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**Working Paper**

## Exchange Rate Regimes Past, Present and Future

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A detailed black and white engraving of three figures in historical attire. The figure on the left is a man in a long coat and hat, holding a staff. The central figure is a woman in a long, flowing dress and a tall, pointed hat, also holding a staff. The figure on the right is a woman in a long, patterned dress and a tall, pointed hat, holding a staff. The background is a textured, light-colored surface.

WORKING PAPER 92  
EXCHANGE RATE REGIMES PAST,  
PRESENT AND FUTURE

WITH CONTRIBUTIONS BY

MICHAEL D. BORDO, JOSEF CHRISTL  
AND CHRISTIAN JUST, HAROLD JAMES

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## Editorial

This Working Paper contains a set of three papers which were presented at an international conference organized by the Oesterreichische Nationalbank in cooperation with the Reinventing Bretton Woods Committee, Vienna, June 20 – 22, 2004.

The papers by *Michael Bordo* and *Harold James* discuss exchange rate regimes issues from an international perspective. *Michael Bordo* takes the very long view starting out with the Gold Standard at the beginning of the 20<sup>th</sup> century, while *Harold James*' focus is on the time of the Bretton Woods Regime.

*Josef Christl* and *Christian Just* discuss European Monetary Integration and look in a comparative way into the future. Are there any lessons to be drawn from the European experience?

We are confident that these papers make for interesting reading for academics and practitioners alike who are interested in this subject matter. The papers, together with the other contributions at the above mentioned conference, will be published in the Conference Proceedings. Useful comments by two anonymous referees are gratefully acknowledged.

Eduard Hochreiter

November 3, 2004



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**Exchange Rate Regimes for the Twenty–First Century:  
An Historical Perspective.**

Michael D. Bordo  
**Rutgers University and  
NBER**

**Prepared for the conference on “60 years of Bretton Woods Governance of the  
International Financial System looking Ahead” Austrian National Bank. Vienna  
June 20-22 2004.**



# Exchange Rate Regimes for the Twenty–First Century: An Historical Perspective

Michael D. Bordo

## 1. Introduction

The choice of exchange rate arrangements that countries face at the beginning of the twenty first century is considerably greater and more complicated than they faced at the beginning of the twentieth century yet the basic underlying issues haven't changed radically. In this paper I consider the subject of exchange rate regime choice from an historical perspective.

At the beginning of the twentieth century the choice was obvious - - join the gold standard, all the advanced countries have done it. Floating exchange rates and fiat money are only for profligate countries. At the beginning of the twentieth century, the choice I will argue is also becoming more obvious - - go to floating exchange rates, all the advanced countries have done it.<sup>1</sup> Moreover in both eras, the emerging markets of the day tried to emulate the advanced countries but in many cases had great difficulties in doing so (Bordo and Flandreau 2003). What happened in the past century to lead to this about face?

Actually of course, the choice today is much more complicated than I have just alluded to. Indeed rather than two options there are many more ranging from pure floats

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<sup>1</sup> In the pre 1914 period, there were also a number of monetary unions and currency boards. Two types of monetary unions prevailed: international unions such as the Latin monetary union and the Scandinavian monetary union, which basically involved arrangements for standardizing gold and silver coins and the clearing of payments; and national monetary unions, such as the United States, Germany and Italy, which involved the complete economic and political integration of the member states with a common currency (Bordo and Jonung 2000). Currency boards which originated in this period were run by the British and the French in a number of their colonies. (Schwartz 1992).

through many intermediate arrangements to hard pegs like currency boards, dollarization and currency unions.

In this paper I will look at the issue from the perspective of both the advanced countries, who generally have a choice and the emergers who have less of one and who often emulate what the advanced countries have done. Section 2 surveys some of the theoretical issues involved beginning with a taxonomy of regimes. We first discuss the Mundell Fleming criterion and its two offshoots: the trilemma and optimum currency area. We then consider the approaches focusing on credibility and a nominal anchor. Finally we look at the recent bipolar view which emphasizes credibility and financial development. Section 3 examines the empirical evidence on the delineation of regimes and their macro performance. Section 4 provides a brief history of monetary regimes. Section 5 concludes with some policy issues.

## **2. Theoretical Issues from an Historical Perspective**

The menu of exchange rate regimes has evolved over the past century pari pasu with developments in theory. Below I survey some of the principal developments with an historical perspective. Before we do this I present a modern day taxonomy of exchange rate arrangements in Table 1.

### **Modern Exchange Rate Arrangements**

Table 1 contains a list of 9 arrangements prevalent today. They are arranged top to bottom by the degree of fixity. Modern fixed arrangements include: truly fixed arrangements like the recent CFA franc zone; currency boards in which the monetary authority holds 100 % reserves in foreign currency against the monetary base, the money

supply expands or contracts automatically with the state of the balance of payments and there is no role for discretionary monetary policy including a lender of last resort; dollarization which goes one step forward and eliminates the national currency completely; and currency unions in which the members adopt the same currency.

Intermediate arrangements run the continuum from: an adjustable peg under which countries can periodically realign their pegs; to crawling pegs in which the peg is regularly reset in a series of devaluations; to a basket peg where the exchange rate is fixed in terms of a weighted basket of foreign currencies; to target zones or bands where the authorities intervene when the exchange rate hits pre announced margins on either side of a central parity.

Floating exchange rates are divided into: free floats where the authorities do not intervene and allow the exchange rate to be determined by market forces; and managed floats where intervention is done to lean against the wind.

The demarcating line between fixed and intermediate arrangements is if the policy to fix is an institutional commitment. The line between intermediate and floating is if there is an explicit target zone around which the authority intervenes (Frankel 2002).

## **Table 1 Exchange Rate Regimes**

### **I. Fixed Arrangements**

- a) Currency Unions
- b) Currency Boards (dollarization)
- c) Truly fixed exchange rates

### **II. Intermediate Arrangements**

- a) adjustable pegs
- b) crawling pegs
- c) basket pegs
- d) target zone or bands

### **III. Floats**

- a) managed floats
- b) free floats

Source: Frankel (1999).

## **Theoretical Perspectives**

The traditional view on the choice of the exchange rate regime a century ago was very simple. It was between specie standards and fixed exchange rates on the one hand, and fiat money and floating on the other. The prevalent view was that adherence to a specie standard meant adherence to sound money i.e. predictable policies that maintained stable price levels (as well as fiscal probity i.e. balanced budgets) and avoiding the transactions costs of exchanging different currencies into each other. By 1900, most nations had switched away from silver and bimetallic standards and adhered to the gold standard. Fiat money and floating was considered to be a radical departure from fiscal and monetary stability and was only to be tolerated in the event of temporary emergencies such as wars or financial crises. Countries which followed fiat money and permanently floated such as Austria-Hungary, and Spain were viewed with disfavor.

In the interwar period, the return to the gold standard was short-lived, ending with the Great Depression. The return to the gold standard was preceded by widespread floating as was the period following it. The contemporary perspective on the experience with floating in the interwar was that it was associated with destabilizing speculation and beggar thy neighbor devaluations (Nurkse 1944). This perception lay at the root of the creation of the Bretton Woods adjustable peg in 1944. The currency arrangements that many countries signed onto after Bretton Woods combined pegged exchange rates with parities fixed in terms of dollars, the dollar pegged to gold, narrow bands of 2 ½ percent around parity and the right to change parity in the event of a fundamental misalignment. It was supposed to combine the advantages of the gold standard (sound money) with those of floating (flexibility and independence).

The difficulties that member nations had in finding a parity consistent with balance of payments equilibrium and the currency crises that attended the realignments of parities in the early years of the Bretton Woods system (Bordo 1993), set the stage for the perennial debate between fixed versus flexible exchange rates. Milton Friedman (1953) in reaction to the conventional (Nurkse) view made the modern case for floating. According to Friedman, floating has the advantage of monetary independence<sup>2</sup>, insulation from real shocks and a less disruptive adjustment mechanism in the face of nominal rigidities than is the case with pegged exchange rates.

Mundell (1963) extended Friedman's analysis to a world of capital mobility. According to his analysis (and that of Fleming 1962), the choice between fixed and floating depended on the sources of the shocks, whether real or nominal and the degree of capital mobility. In an open economy with capital mobility a floating exchange rate provides insulation against real shocks, such as a change in the demand for exports or in the terms of trade, whereas a fixed exchange rate was desirable in the case of nominal shocks such as a shift in money demand.

The Mundell Fleming model led to two important developments in the theory of exchange rate regime choice: the impossible trinity or the trilemma; and the optimal currency area. According to the trilemma, countries can only choose two of three possible outcomes: open capital markets, monetary independence and pegged exchange rates. According to this view the gold standard flourished with open capital markets and fixed exchange rates because monetary independence was not of great importance. It collapsed in the interwar because monetary policy geared to full employment became important.

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<sup>2</sup> By monetary independence, Friedman presumed that monetary authorities would follow stable monetary policies.

Bretton Woods encompassed pegged exchange rates and monetary independence by condoning extensive capital controls. It collapsed in the face of increasing difficulty of preventing capital mobility (Obstfeld and Taylor 1998). More recently the trilemma has led to the bipolar view that with high capital mobility the only viable exchange rate regime choice is between super hard pegs (currency unions, dollarization or currency boards) and floating; and indeed the advanced countries today either float or are part of the EMU.

An optimal currency area (OCA) is defined as “a region for which it is optimal to have a single currency and a single monetary policy” (Frankel 1999 p. 11). The concept has been used both as setting the criteria for establishing a monetary union with perfectly rigid exchange rates between the members with a common monetary policy, and the case for fixed versus floating. The criteria posed by Mundell (1961), Kenen (1969) and McKinnon (1963) for whether a region such as Europe was an OCA involved the symmetry of shocks in the member states, the degree of openness, the degree of labor mobility and the ability to make fiscal transfers.

In simplest terms, based on OCA theory, the advantages of fixed exchange rates increases with the degree of integration. Recent approaches suggest that the OCA criteria also work in an ex post sense - - that joining a currency union by promoting trade and integration increases the correlation of shocks (Frankel and Rose 2002).

### **Credibility and Exchange Rate Regime Choice**

A different set of criteria for exchange rate regime choice than that based on the benefits of integration versus the benefits of monetary independence, is based on the

concept of a nominal anchor. In an environment of high inflation, as was the case in most countries in the 1970s and 1980s, pegging to the currency of a country with low inflation was viewed as a precommitment mechanism to anchor inflationary expectations.

This argument was based on the theory developed by Barro and Gordon (1983) who discuss the case of a central bank using discretionary monetary policy to generate surprise inflation in order to reduce unemployment. They demonstrate that with rational expectations the outcome will be higher inflation but unchanged employment because the inflationary consequences of the central bank's actions will be incorporated in workers' wage demands. The only way to prevent such time inconsistent behavior is by instituting a precommitment mechanism or a monetary rule.

In an open economy a pegged exchange rate may promote such a precommitment device, at least as long as the political costs of breaking the peg are sufficiently large. This argument was used extensively in the 1980s to make the case for the ERM in Europe, and in the 1990s for currency boards and other hard pegs in transition and emerging countries.

### **Domestic Nominal Anchors**

The case for floating has also been buttressed by the theoretical work on credibility and time consistency. Designing a set of domestic institutions that will produce low inflation and long-run expectations of low inflation is consistent with the monetary independence associated with floating rates. The creation of independent central banks (independent from financing fiscal deficits) and establishing low inflation



targeting in a number of advanced countries represents a domestic precommitment strategy (Svensson (2002)).

### **Emerging Market Perspectives**

The recent spate of emerging market crises in the 1990's has led to attention to the plight of these countries who have opened up their financial markets. Most of the countries hit by crises had pegged exchange rates. According to the trilemma view, the crises were a signal that open capital markets, monetary independence and pegs were incompatible as had been the case with the advanced countries in Bretton Woods and the ERM in 1992. Consequently many observers have put forward the bipolar view - - that the only options for these countries are super hard pegs or floating.

Yet the emergers face special problems which make this simple dichotomy a bit more difficult than is posed. First in the case of hard pegs such as currency boards (or dollarization), currency crises are ruled out (to the extent the currency board is followed) but banking crises are still possible and without a monetary authority they cannot be contained (Chang and Velasco 2001). Related to the inability to act as Lender of Last Resort is the inability to have the monetary policy flexibility to offset external real shocks. Moreover establishing a currency board or going the next step and dollarizing works best if the currency picked for the peg is of a country that has extensive trade with the emerger and has a history of monetary stability.

Second is the so called problem of 'Original Sin' (Eichengreen and Hausmann 1999). Because many emerging countries are financially underdeveloped and they may have had a history of high inflation and fiscal laxity, they are not able to either borrow in

terms of their own currencies long-term or to borrow externally except in terms of foreign currencies such as the dollar. This according to Eichengreen and Hausmann, exposes them to the serious problems of both maturity and currency mismatches. In the face of a currency crisis a devaluation can lead to serious balance sheet problems, widespread bankruptcies and debt defaults. This was the case in East Asia in the 1990's and also when Argentina exited from its currency board in 2001. The 'Original Sin' creates problems for emergers who float and even those who adopt hard pegs.

A third problem for emergers that float is that devaluations may have no effect on the real economy in the face of widespread indexation or a history of high inflation. Thus there may be very high pass through from the exchange rate to the price level or in the case of original sin, as mentioned above, devaluing may actually be contractionary.<sup>3</sup>

These problems suggest that intermediate arrangements may still have a role to play for such countries. Also it is important to distinguish between, on the one hand, middle and large emerging countries who have the potential and are moving in the direction of, the policies of the advanced countries and adopting domestic nominal anchors such as inflation targetting cum independent central banks; and on the other hand small very open emergers who may fare best with currency unions.

### **3. Measurement and Performance**

In making the correct exchange rate regime choice it is very important to have some empirical evidence on economic performance. An extensive literature has developed to answer the question which regime performs best. Before discussing what

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<sup>3</sup> Although Cespedes, Chang and Velasco (2000) demonstrate that positive Mundell-Fleming aggregate demand enhancing effects may outweigh such negative balance sheet effects.

the evidence seems to say however, we need to consider an important methodological question. How do we classify exchange rate regimes?

Two answers are given: either *de jure* or *de facto*. The former establishes a list of regimes like Table 1 and then classifies countries by what they say they do. This is the approach that has been taken by the IMF until quite recently and authors like Ghosh et al (2003). It is justified on the grounds that announcing a regime has important forward looking credibility effects.

The second approach by authors such as Calvo and Reinhart (2000) and Levy-Yeyati–Sturznegger (2001) starts with the premise that for various reasons including ‘fear of floating’ and lack of credibility, countries do not do exactly what they say they do. This approach tries to correct for this problem by using observed behavior of the exchange rate, international reserves and other variables to infer a *de facto* classification scheme.<sup>4</sup>

The most notable study using the *de jure* scheme is by Fischer (2001) who reports evidence of hollowing out - - between 1991 to 1999, the fraction of IMF members that follow intermediate regimes fell from 62 % (98 countries) to 34 % (63 countries). The fraction with hard pegs rose from 16 % (25) to 24 % (45) while the fraction that floats increased from 23 % (36) to 42 % (77). However Frankel’s (2002) most recent look at the data argues that more emerging countries in the past decade have opted for flexible rates than hard pegs. A similar conclusion is also reached by Larain and Velasco (2001), their Table 1 shows that in 1976 86 % of developing countries maintained pegged

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<sup>4</sup> Since 1999, the IMF has also adopted a *de facto* classification system. See IMF (1999), chapter IV for details.

arrangements, by 1996 only 45 % had some kind of peg and 52 % had a flexible exchange rate arrangement.

The de facto camp doubts the meaning of these data because many peggers frequently have realignments (Obstfeld and Rogoff 1995) referred to as “soft pegs” and many floaters are reluctant to float referred to as “hard floats” because they have ‘fear of floating.’ This is because they view devaluations as contractionary because of adverse balance sheet effects (Calvo and Reinhart 2002). Levy-Yeyati and Sturznegger (2000) attempt to account for these problems by constructing a de facto classification scheme based on the volatility of exchange rates and international reserves. They use cluster analysis to classify countries into the three groups of pegged, intermediate and flexible. Their evidence for the 1990’s confirms the significant presence of both “soft pegs” and “hard floats.” Indeed, they doubt the evidence on hollowing out - - they find about equal representation in each of the three categories.

Finally, in a very recent paper, Reinhart and Rogoff (2002) construct a new “natural” classification scheme. They use a new database on dual and parallel currencies as well as chronologies of the exchange rate history for all Fund members for the past half-century, to construct a 15 category schema. They also distinguish floating by high inflation countries (freely falling) from floating by others. Like Levy-Yeyati and Sturznegger they find extensive evidence of soft pegs and hard floats - - since the 1980s over 50 % of de jure floats are de facto pegs and approximately half of de jure pegs were floats.

## **Evidence**

Table 2 presents some evidence on macroeconomic performance on inflation and real per capita growth for all the countries covered by the IMF for the past three decades. It compares some of the principal findings of the de jure and de facto classification schemes.

Panel A compares data from the Levy-Yeyati and Sturznegger (LYS) studies with the IMF de jure classification as used by Ghosh et al (2003) for three broad categories: floats, intermediate and pegged regimes. According to the de jure classification, floats had higher inflation rates and pegs the lowest. For LYS intermediate regimes had the highest inflation, followed by floats and pegs. Both criteria support the common wisdom and the historical evidence that pegs deliver low inflation.

With respect to real per capita growth, under the IMF classification intermediate regimes deliver the highest growth, floats the lowest. Under LYS, floats rank the highest, followed by pegs and intermediate regimes. These results likely reflect the reclassifying by LYS of countries with fear of floating as intermediate regimes, leaving mainly advanced countries in the floating category.

Panel B compares the evidence from the Reinhart Rogoff (RR) study with the IMF de jure classification scheme. RR shows five regimes. They demarcate floating into three: freely floating, freely falling (defined as countries with high inflation rates and depreciation rates above 40%) and managed floating. Pegs represent hard pegs and limited flexibility characterizes all the rest. RR's de facto results are very different from the de jure ones and from LYS. Because they strip out freely falling from floating they pick up the good inflation performance of the high-income countries seen in figure 1.

Also hard pegs do not appear to be a panacea against inflation. Finally growth performance is by far the best for the freely floaters, a result similar to LYS.

The de facto evidence on performance is markedly different from the de jure evidence from the IMF. The fact that both LYS and RR using very different methodologies associate floating with high growth and that floating is not associated with the high inflation seen in the de jure classification suggests that how regime classification is done has important implications for the issue of regime choice.<sup>5 6</sup>

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<sup>5</sup> Ghosh et al (2002) using the de jure definitions find from regressions of inflation on exchange rate regime dummies and other variables such as money growth, openness, terms of trade shocks that the differences between pegged and floaters narrows considerably. For real per capita growth they cannot detect any significant differences across regimes.

<sup>6</sup> Juhn and Mauro (2002) using both the de jure and LYS de facto classification schemes and a large panel data set from 1990 to the present, find that no robust empirical regularities can be found to explain exchange rate regime choice. Whereas Levy-Yeyati, Stuznegger and Regio (2002) using the LYS classification scheme and panel data (demarcated into industrial and emerging countries) from 1974 to the present, find that exchange rate regime choice for industrial countries is explained by OCA type variables, while for the emergers balance sheet effects and the capital account are important.

**Table 2: De Jure vs. De Facto Exchange Rate Classification**

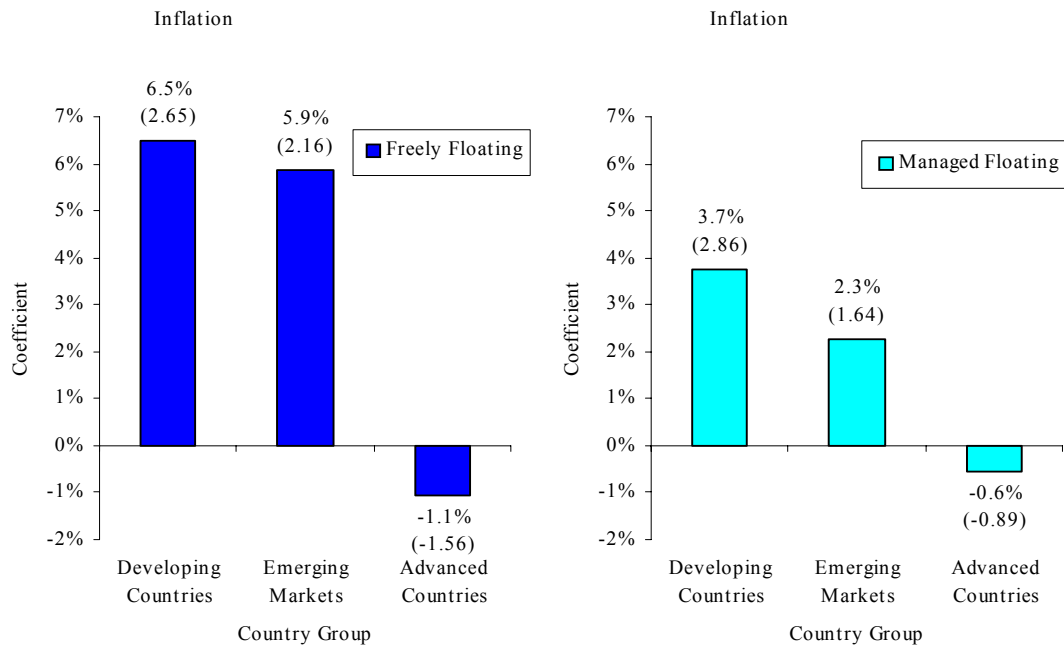
<b>A. Levy-Yeyati and Sturznegger (2000,2001) 1974-1999 (Annual) 154 countries</b>										
	<b>Inflation</b>						<b>Real per Capita Growth</b>			
	<b>Float</b>	<b>Intermediate</b>	<b>Peg</b>				<b>Float</b>	<b>Intermediate</b>	<b>Peg</b>	
<b>IMF</b>	22.3	20.2	16.7				1	2	1.2	
<b>LYS</b>	14.2	38.3	9.7				1.9	0.8	1.5	
<b>B. Reinhart –Rogoff (2002) 1970-2001 (Annual) 153 countries</b>										
	<b>Inflation</b>				<b>Real per Capita Growth</b>					
	Freely Float	Freely Falling	Managed float	Limited float	Peg	Freely Float	Freely Falling	Managed float	Limited float	Peg
<b>IMF</b>	174	n.a.	74.8	5.7	38.8	0.5	n.a.	1.9	2.2	1.4
<b>RR</b>	9.4	443.3	16.5	10.1	15.9	2.3	-2.4	1.6	2.4	1.9

A recent IMF Board paper (Rogoff et al 2003) extensively reviewed the costs and benefits of both approaches and the relative merits of the different de facto empirical schemes. The paper then extends Reinhart and Rogoff's natural classification to the exchange rate experiences of all IMF members divided into the following categories: developing countries with limited capital market access; emerging market countries with access to international capital markets and advanced countries.

They find that macro performance across regimes varies dramatically between these three groups. Figure 1 displays the salient evidence. Panels A and B show the evidence on inflation. It is based on regression analysis of exchange rate regime dummies on inflation conditional on a number of variables including money growth. The figure clearly shows that developing countries benefit from adhering to pegged arrangements; for emergers inflation rises with flexibility possibly explaining their 'fear of floating', while for advanced countries flexible rates deliver the lowest inflation.

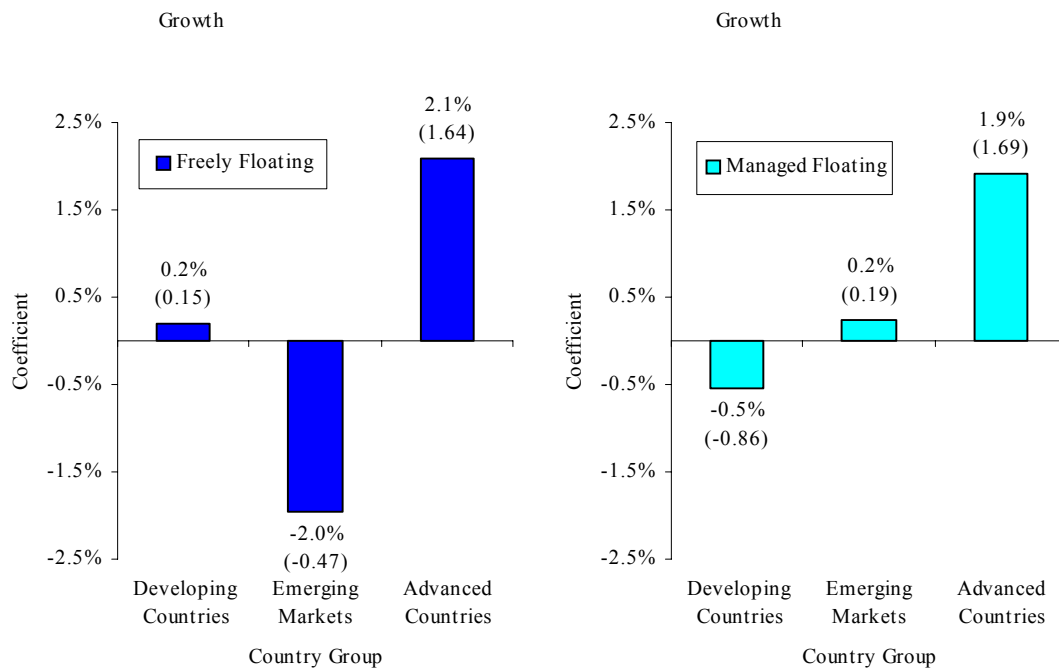


**Figure 1: Performance of Floating Regimes Relative to Pegs**



Panel C and D present the evidence on the real per capita growth. It shows that developing countries perform best with pegged regimes, advanced countries do best with floating; and the emerging countries are in between.

**Figure 1 (continued): Performance of Floating Regimes Relative to Pegs**



Note: Figures in parentheses are t-statistics. The bars depict differences in performance relative to pegged exchange rate regimes, conditioning on a range of other variables.

The evidence highlights the beneficial influence of flexible regimes as countries become more advanced. This may reflect the views that floating permits more rapid adjustment following shocks and that with more mature financial sectors advanced countries are not subject to the offsetting balance sheet risk of floating. These themes I develop below in an historical context.

#### 4. History of Exchange Rate Regime Choice

Exchange rate regime choice has evolved considerably in the past century. Table 3 shows a very rough chronology of the exchange rate regimes the world has seen since 1880. They have expanded considerably from the simple choice between the gold

standard and fiat to the 15 regimes demarcated by Reinhart and Rogoff. Yet the basic choice between fixed and flexible still remains at the heart of the matter.

**Table 3: Chronology of Exchange Rate regimes 1880-2000**

1880-1914	Specie: Gold Standard (bimetallism, silver); currency unions, currency boards; floats
1919-1945	Gold Exchange Standard; floats; managed floats; currency unions (arrangements); pure floats; managed floats.
1946-1971	Bretton Woods adjustable peg; floats (Canada); Dual/Multiple exchange rates
1973-2000	Free float; managed float, adjustable pegs, crawling pegs, basket pegs, target zones or bands; fixed exchange rates, currency unions, currency boards.

My approach in this section is not to repeat the history of international monetary regimes which is well covered by Eichengreen (1996) and Bordo and Schwartz (1999) but to focus on a comparison of monetary regimes in the two eras of financial globalization, 1880-1914 and the present. Such a comparison highlights two key issues of relevance for today: a) the different choices facing advanced and facing emerging countries; b) the role of financial integration. In what follows I examine the experience of the advanced (core) countries and the emerging (periphery) countries in historical perspective.

The core countries of the pre 1914 era: Great Britain, France, the Netherlands, Germany and the U.S. as well as a number of smaller western European countries and the British Dominions adhered to the classical gold standard. The gold standard by 1880 had evolved from the historic specie regime based on bimetallism. An extensive

historiography covering this evolution emphasizes factors such as: accidents of history - - the Franco Prussian war and massive silver discoveries in the U.S; attempts to follow the example of the leading commercial nation, Great Britain, which had been on a de facto gold standard since 1717; network externalities and the technology of coinage.

The essence of the classical gold standard for the core countries was a credible commitment to maintain gold convertibility i.e. following the gold standard rule. Adhering to gold convertibility can be viewed as a commitment mechanism to the pursuit of sound monetary and fiscal policies (Bordo and Kydland 1996). The commitment by these countries to gold convertibility was credible based on their past performance. Moreover the gold standard rule was embedded in a long history of financial development. This includes the creation and successful servicing of public debt, by the Dutch and the British in the 17<sup>th</sup> and 18<sup>th</sup> centuries, the founding of central banks such as the Bank of England in 1694, and the development of stock markets, banking systems, and non bank financial intermediaries in the eighteenth and nineteenth centuries (Rousseau and Sylla 2002).

The rule followed was a contingent rule: adhere to gold parity except in the event of a well understood emergency such as a financial crisis or a war. Under such circumstances a temporary departure from parity was tolerated on the understanding that it would be restored once the emergency had passed. Because these countries demonstrated their willingness to follow such a rule e.g. the British experience in the Napoleonic war and the U.S in the Civil war, and to subsume domestic policy goals to the external constraint, they had earned the credibility to have a measure of short-term policy

flexibility that enabled them to buffer transitory shocks. Indeed temporary departures from gold parity would be offset by stabilizing short term capital flows.

Moreover the gold points can be viewed as a modern credible "target zone" a la Krugman (1991) which allowed the monetary authorities some flexibility for example to conduct expansionary monetary policy to lower short-term interest rates and thus compensate for declining output. The decline in short-term interest rates would be offset by a rise in the exchange rate on the expectation that the parity would be restored (Bordo and MacDonald 2004).

Today, the advanced countries (with the principal exception of the European Union) have floating exchange rates. To a certain extent the current trend towards floating has some resemblance to the classical gold standard in which the fluctuation margins have been widened to give more flexibility. The key difference between then and now is that the nominal anchor -- gold parity around which the target zone operated - - has been jettisoned and a domestic fiat nominal anchor has been substituted in its place, which allows exchange rate flexibility without the constraint of a target zone. The two systems are similar in spirit because they are each based on credibility. They also had independent central banks, minimal regulation of the financial system and the absence of capital controls.

In this sense, the evolution from the gold standard to today's managed floating represents a major technical improvement. Today's regime has adopted the credibility or what Bordo and Schwartz (1999) call the "convertibility principle" of the classical gold standard without the high resource costs and the "vagaries" of the gold market which plagued the classical gold standard. Also, the development of deep and liquid foreign

exchange and other financial markets have aided the smooth operation of a floating rate system.

A consequence of this analysis is that logically, the pre 1914 core countries that had developed strong money and financial markets and institutions before World War I ought to have floated -- something which they did not. The possible reasons why the logic of the target zone was not pushed further include: the protection that gold gave to bond holders against inflation risk and the political constituency thus created; and the path dependency of gold as money.

### **Middle Years: 1914 -1972**

What happened in the middle years of financial deglobalization between 1914 and 1973? According to the trilemma view of Obstfeld and Taylor (2002), the gold standard with free capital mobility had to be jettisoned in the advanced countries in the face of growing demands by an expanding electorate and organized labor to stabilize the business cycle. More likely it was abandoned because of the shocks and imbalances caused by World War I.

The gold standard was reinstated as a gold exchange standard in 1925. Central banks supplemented their gold reserves with foreign exchange (sterling and dollar). The gold exchange standard collapsed in 1931. Its brief life is attributed to a number of fatal flaws in its design (see Bordo 1993) and to a decline in credibility reflecting the fact that consequent upon the growth of democracy monetary authorities had the domestic goal of full employment to satisfy as well as to maintain gold convertibility (Eichengreen 1992)

The result was capital controls in the 1930's and the adjustable peg in the Bretton Woods era after World War II. In the late 1960s, the latter was blown apart, leading to the current floating regime. The demise of the Bretton Woods was precipitated by the pursuit of financial policies inconsistent with maintaining the pegged rate system by the key countries, especially the U. S., which had used expansionary monetary and fiscal policies to finance the Vietnam war; as well as by the pressure of international financial integration in spite of the capital controls (Bordo 1993).

### **Core versus Periphery: History of the Periphery**

The periphery countries faced a vastly different exchange rate experience from the core countries in the pre 1914 era of globalization as they have in the recent era. Pre 1914 in contrast to the core countries, many peripheral countries did not develop the fiscal and monetary institutions that allowed them to credibly follow the gold standard rule. Because they lacked credibility they were not buffered from shocks by the "target zone."

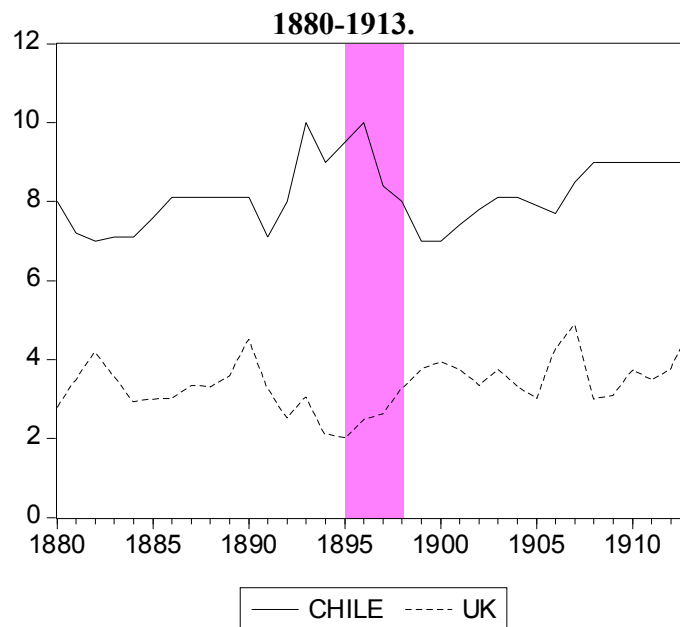
In an advanced country, a shock leading to a depreciating exchange rate could temporarily be offset by lowering interest rates so that output may recover. For the periphery, exchange rate depreciation could trigger capital flight and financial distress. This could occur because the markets do not expect that the exchange rate will be restored by future corrective policies. It also could occur because a substantial amount of external debt is denominated in a foreign currency.

Because of this problem floating did not create much room for the periphery countries to conduct active monetary policies compared to the experience of the core

countries. But going onto gold did not buy immediate credibility for them either as illustrated by the levels of short term interest rates in a number of typical members of the periphery.

Figure 2a to 2e show that the weaker members of the gold club faced higher short term interest rates even when on gold than is consistent with their actual exchange rate record. This suggests some kind of "peso" problem. The high short-term rates faced by Chile, Greece, Portugal, Italy or Russia, during their more or less extended flirt with gold suggests that problems that the modern periphery has with pegging, as evidenced in the emerging financial crises of the 1990s, have nineteenth century precedents. The fact that even when on gold, these countries could face high short-term rates, might explain why some of them ended up floating.

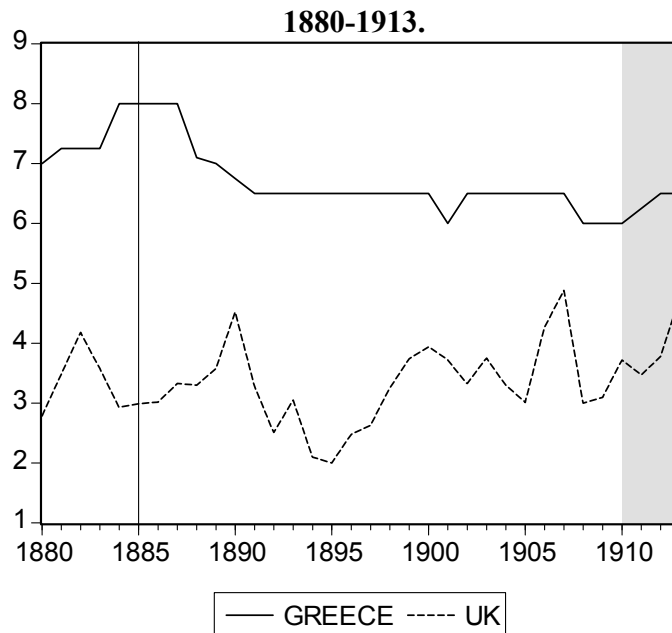
**Figure 2a: Short -Term Interest Rates (Bank Rates), Chile (compared to UK)**



Shaded area represents the period when Chile was on the gold standard.  
Source: See Bordo and Flandreau (2003)

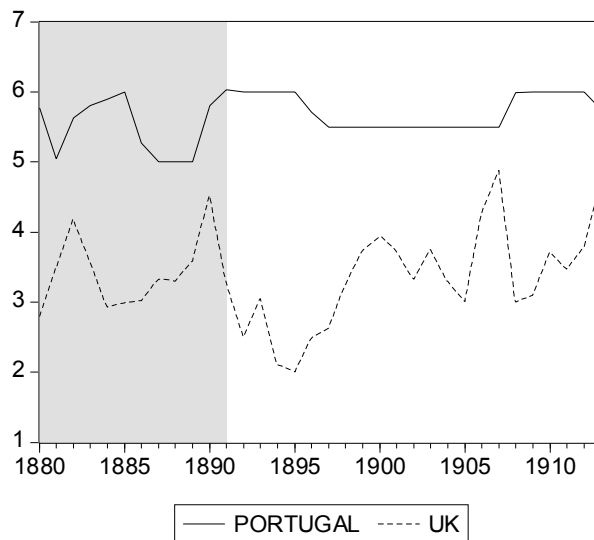


**Figure 2b: Short -Term Interest Rates (Bank Rates), Greece (compared to UK)**



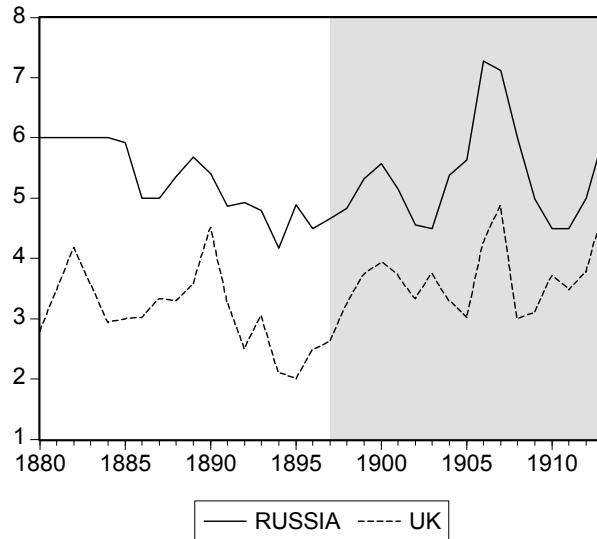
Shaded area represents the period when Greece was on the Gold Standard (December 1884-July 1885). Source: See Bordo and Flandreau (2003)

**Figure 2c: Short -Term Interest Rates (Bank Rates), Portugal (compared to UK)**  
**1880-1913.**



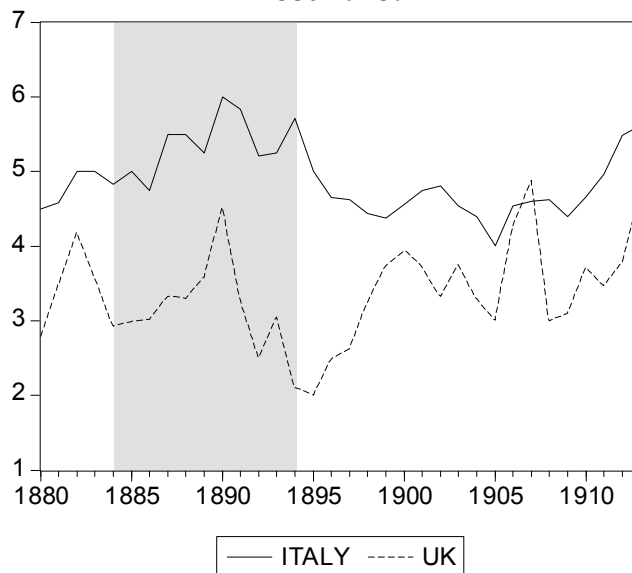
Shaded area represents the period when Portugal was on the gold standard. Source: See Bordo and Flandreau (2003)

**Figure 2d: Short -Term Interest Rates (Bank Rates), Russia (compared to UK) 1880-1913.**



Shaded area represents the period when Russia was on the gold standard.  
Source: See Bordo and Flandreau (2003)

**Figure 2e: Short -Term Interest Rates (Bank Rates), Italy (compared to UK) 1880-1913.**



Shaded area represents the period when Italy was on the gold standard. Source: See Bordo and Flandreau (2003)

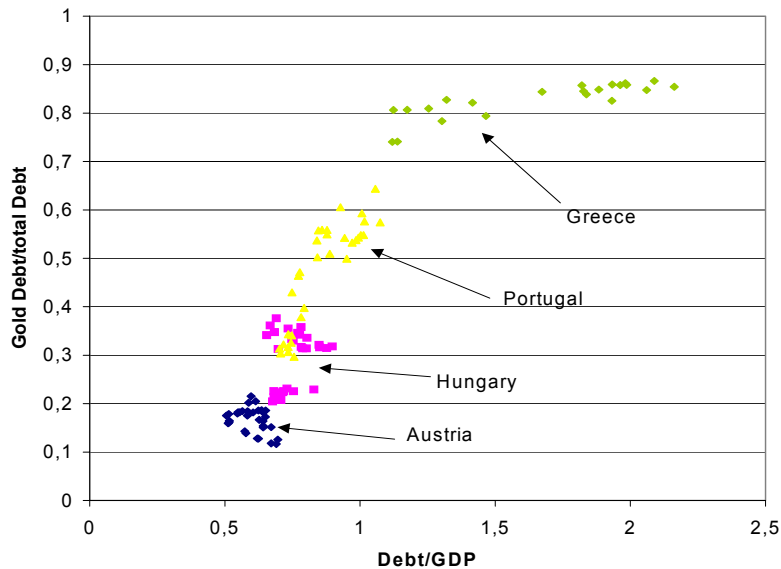
### **Fear of Floating, 19<sup>th</sup> Century Style: A New View of the Gold Standard**

The modern "fear of floating" problem whereby countries which say they float do not, for the reasons mentioned above discussed by Calvo and Reinhart (2002) seem to have been prevalent pre 1914. If fixing was quite painful under the gold standard for many of the peripheral countries, floating could be just as problematic for them as is the case today. This was due to pervasive problems of currency mismatch arising from the inability for underdeveloped borrowing countries to issue foreign debt in their own currencies. This problem which prevails today Barry Eichengreen and Ricardo Hausman refer to as 'Original Sin.' The bonds of peripheral countries pre 1914 borrowing in London, Paris or Amsterdam would always contain clauses tying them in gold to the currency of the country where the bond was issued - "the gold clauses."

This practice may have been the solution to a commitment problem. While local issues could be easily inflated away, foreign issues with gold clauses provided safeguards, precisely because they in turn induced governments to be on their guard. See figure 3 which shows that the share of gold debt was an increasing function of total indebtedness for a number of peripheral countries.

Moreover adhering to the gold standard was not a perfect substitute for the gold clauses. Since the club of countries that could issue debt abroad denominated in their own currency was much narrower than the set of countries on the gold standard. Bordo and Flandreau (2003) Table 3 contains a list of "senior" sovereigns in London from Burdett's Official Stock Exchange Intelligence. The countries whose bonds were listed in terms of their own currencies were: the U.K., U.S., France, Germany, Belgium, Netherlands, Switzerland and Denmark.

**Figure 3: Total Indebtedness and Currency Mismatch: Austria, Hungary, Portugal, Greece 1880 – 1913**



Source: Crédit Lyonnais Archives.

Moreover adhering to the gold standard was not a perfect substitute for the gold clauses. Since the club of countries that could issue debt abroad denominated in their own currency was much narrower than the set of countries on the gold standard. Bordo and Flandreau (2003) Table 3 contains a list of “senior” sovereigns in London from Burdett's Official Stock Exchange Intelligence. The countries whose bonds were listed in terms of their own currencies were: the U.K., U.S., France, Germany, Belgium, Netherlands, Switzerland ad Denmark.

The inability to assume debt in their own currency meant that having a large gold debt and experiencing an exchange rate crisis could have devastating consequences when a country embarked on a spending spree and public debt increased. The share of gold denominated debt increased in turn. This created an explosive mismatch.

The crises of the 1890s very much like those of the 1990s provided evidence of the mechanism at work. The crises started with Argentina where the expansion of the gold debt, accompanied by paper money issue, pushed the level of the debt burden to unsustainable heights. Public debt crises in Portugal and Greece (1892 and 1893) both resulted from the depreciation of the exchange rate that had brought these countries public debts to unsustainable levels.

The responses to these problems induced by high debts and financial vulnerability were also surprisingly modern. Some countries such as Spain and Portugal, continued to float but minimized their exposure by limiting their borrowings abroad. Some others such as Russia or Greece developed de facto currency boards. They accumulated gold reserves beyond what was statutorily necessary and in effect adopted gold cover ratios that were consistently above 100%. Yesterday like today there seems to have been a hollowing out as a response to financial crises.

Clearly, in view of the narrow list of countries that were able to float debts in their own currency, much of the emerging world was bound to face currency mismatches. From this point of view, gold adherence became for those willing to protect themselves against international financial disturbances a second best solution. It is not that a gold standard immediately brought credibility. Rather it served as an insurance mechanism and in this sense fostered globalization. In other words the spread of the gold standard in the periphery may have been an endogenous response to the gold clauses: as soon as the price of this insurance decreased (as was the case during the gold inflation of 1897-1914), the gold standard expanded, as more and more countries found it less dangerous to borrow with gold clauses since the risk of being tipped off gold declined.

The interpretation of the seemingly opposite nature of global exchange rate regimes in the two big eras of globalization (fixed exchange rates back then, floating ones today) has put at the center of the picture the role of financial vulnerability and financial crises. To some extent, the Baring crises yesterday played a role similar to the crises of the late 1990s in reminding emerging floaters about the dangers of an impervious floating exchange rate. As a result while developed countries have always had the temptation and the ability to float (with floating restricted yesterday by path dependency and the difficulty of creating domestic institutions that could create a domestic nominal anchor) the periphery has always faced serious difficulties in floating, viewing the gold standard yesterday, and hard pegs today as a second best solution.

Bordo and Flandreau (2003) present econometric evidence for the pre 1914 and the 1973 eras linking the dominant regime followed - - the gold standard pre 1914, floating today, to financial maturity (defined as open and deep financial markets, stable money and fiscal probity) which they proxy by financial depth, measured as the ratio of broad money to GDP. Before 1914 when the gold standard was the dominant regime they find that countries adhering to gold to have greater financial depth than those that did not post 1976, when floating was the dominant regime. They found, in general, that countries that could successfully operate pure floats were more financially developed than those which could not.<sup>7</sup>

The key distinction for exchange rate regime choice between core and periphery then; advanced and emerging now; is financial maturity. It is manifested in open and deep financial markets, stable money and fiscal probity. It is evident in the ability to issue

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<sup>7</sup> With the exception of small economies with considerable openness or close trading links to a large country who chose not to float and instead adhered to hard pegs e.g. Hong Kong.

international securities denominated in domestic currency or the absence of ‘Original Sin.’ Indeed, countries that are financially developed, in a world of open capital markets should be able to float as advanced countries do today, just as they successfully adhered to gold before 1914.

Evidence for the core countries that the classical gold standard operated as a target zone with the gold points serving as bands in which credible floating could occur and external shocks be buffered is a presage to the regime followed today. Today's floating is a product of financial maturity and the development of the technological and institutional structures and constraints that allow policy makers to follow stable money and fiscal policy without adhering to an external nominal anchor.

Thus the dynamics of the international monetary system and evolution of the exchange rate regime is driven by financial development and international financial integration. Financial crises such as those of the 1890s and 1990s are the defining moments that reveal the regime fault lines between advanced and emerging countries. The evolution of the gold standard and the movement towards successful floating by advanced countries today required achieving financial maturity. The same will be required for the rest of the world. In the interim intermediate arrangements including impediments to free capital movements will prevail. Financial crises as occurred in the 1890s and the 1990s will also continue to be an important part of the process of regime evolution as an ultimate structuring force.

## **5. Policy Implications**

Which exchange rate arrangement is best? This survey historically agrees with Frankel (1999) who states that “no single currency regime is best for all countries and

that even for a given country it may be that no single currency regime is best for all time.” However the world is evolving towards a floating exchange rate regime which is the regime of the advanced countries which in many ways echoes the movement towards the gold standard a century ago. The principal exception to the pattern seems to be currency unions such as EMU which the European countries have joined ( largely for political reasons) as have a number of small very open economies.

However although the world is evolving toward floating, intermediate regimes still represent a large fraction of all arrangements. Is there still a case for them? The principal case against them of course was the disastrous experience with the adjustable peg under the Bretton Woods system which collapsed under speculative attacks and the recent Asian crises which involved largely crawling peg arrangements.

In reaction to that experience, many observers have made the case for bipolarity. Moreover the ‘fear of floating’ view has made the case that emergers should likely move toward hard pegs rather than floats. Yet both currency boards and dollarization have serious flaws, the principal of which is the absence of a monetary authority to as act as a lender of last resort or to offset external shocks (Larain and Velasco 2001). Moreover currency unions which can overcome those problems need considerable political will to survive in the face of the shocks that inevitably come along (Bordo and Jonung 2000).

Thus in the face of these considerations the case still can be made for intermediate arrangements for emerging countries which are not yet sufficiently financially mature to float. One such arrangement that seems to be a promising path that countries could take on their journey towards floating is Morris Goldstein’s (2002) “ Managed Floating Plus”



scheme.<sup>8</sup> It supplements the inflation targeting cum independent central bank approach that several advanced countries (U.K, Sweden, New Zealand and Canada) follow, with exchange market intervention to offset temporary shocks, a comprehensive reporting system to maintain the level and foreign currency exposures of external debt and perhaps a sequential strategy to the opening up of domestic financial markets to external capital flows. Finally there is still a case for monetary unions for countries that are closely politically and economically integrated or are very small open economies.

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<sup>8</sup> For an interesting discussion of this and other options see Baillu and Murray (2002).

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# Regional Monetary Arrangements - Are Currency Unions the Way Forward?<sup>1</sup>

Josef Christl and Christian Just

## 1. Introduction

After the international financial crises of recent years the debate on the appropriate exchange rate regime has again intensified. Pegged exchange rates were often seen as a major cause of the respective crisis. Since then it has been popular to argue that a hollowing out of the middle of the exchange rate regime choice has occurred. This essentially means that only hard pegs, like currency boards, or independent floats are viable regimes among the continuum of exchange rate regimes. All the middle regimes such as soft pegs or managed floats are argued to be either unsustainable and/or too crisis-prone because they lack credibility and are vulnerable to speculative attacks.

While the Optimal Currency Area (OCA) literature still offers a valid framework for analyzing the choice of an exchange rate regime, in the recent literature on exchange rate regime choice, the concept of “fear of floating” (Calvo and Reinhart, 2002) has become popular. Fear of floating rests on the assumption that highly volatile exchange rates limit gains from trade, increase risk premia on interest rates and lower welfare. While *de jure* classified as floating exchange rates, these *de facto* exchange rate pegs involve high risks as evidenced by the financial crises in emerging market countries (EMCs) over the past decade.

This paper will briefly review the sequencing of economic integration, highlight some aspects of the optimal currency area literature, look at the steps taken in the European Union as well as the new EU member states and will after looking at the current regional integration processes in Latin America and Asia, draw some

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conclusion for other regions in the world. While the macroeconomic challenges that European countries faced in the 1980s were decisively different than the ones Latin America or Asia are confronted with today, the European experience offers some valuable experiences. These principally suggest that it will take time before these regions will meet the criteria necessary to successfully start a currency union and proposes that as an initial step inflation targeting possibly accompanied by some fiscal rule may be a suitable and viable foundation for fostering macroeconomic stability. This stability coupled with stronger institutions and a certain policy convergence could help in the long-run towards achieving the aim of a currency union.

## 2. Steps of integration

Monetary arrangements have a lot to do with the degree of economic integration. But there are no straightforward 'laws' about the degree and depth of regional (economic) integration in the global political economy. Bela Balassa (1962) set out a logical roadmap which places a regional monetary arrangement in the context of regional economic integration. First countries decide to create a free trade area. This could then lead to a common external tariff, thereby producing a *de facto* customs union. Efficiencies would be further generated by the formation of a genuine internal market amongst member countries. The gains of the internal market could be best achieved through further 'deepening' of integration. Therefore, monetary integration - the use of a common currency - would be the next stage. This in turn would generate incentives for further political integration.

A second issue follows from the obvious conclusion of Balassa's work: at what point does the management of economic integration require political integration? At the very least, some pooling of economic sovereignty seems required, and the development of some sort of region-level regulatory authority would seem rational in the circumstances. This does not imply that a new political entity has to be

formed. And whether all forms of integration such as customs unions, common markets and monetary unions must have similar levels of institutionalization remains an open question as well.

The Balassa sequencing however, does not set out a roadmap which exchange rate regime to adopt to accompany regional integration efforts. European countries before joining Economic and Monetary Union (EMU) mostly chose to explicitly or implicitly use the DM as an exchange rate anchor. Today, the new EU member states follow different regimes ranging from currency boards such as in Estonia to free float such as in Poland. Provided macroeconomic policy consistency any exchange rate regime is therefore conceivable with regional integration short of a monetary union.

### **3. Choosing an Exchange Rate Regime**

After the Mexican (1994), the Asian (1997-98), the Russian (1998), the Brazilian (1998/99), the Turkish (2000) and the Argentine (2001) financial crises, the debate on the appropriate exchange rate regime has intensified. This is owing to the fact that pegged exchange rates were very often the root and/or cause of the respective crisis. Since then it has been popular to argue that a hollowing out of the middle of the exchange rate regime spectrum has occurred. This essentially means that only hard pegs and independent floats are viable regimes among the continuum of exchange rate regimes. All the middle regimes such as soft pegs or managed floats are argued to be either unsustainable and/or too crisis-prone because they lack credibility and are vulnerable to speculative attacks.

However, the hollowing-out followers soon went back to the impossible trinity. Fischer (2001) or Mussa (2000) recognize that managed floating and other middle regimes are viable for many countries with certain conditions of capital mobility and economic development. Interior solutions then turn out to be the best for

many (small) countries with low capital mobility, underdeveloped capital and foreign exchange markets and diversified trade structures.

The choice of an exchange rate regime depends on several factors. As analytical tools two theories have been advanced that may guide policy-makers and economists alike.

### 3.1 Optimal Currency Criteria

The classical theory of Optimum Currency Areas (OCA) developed by Mundell, McKinnon and Kenen, defines an optimum currency area as a geographical region in which member countries should use absolutely fixed exchange rates or have a common currency. Mundell and his followers stipulated several criteria to assess whether a country should belong to an optimal currency area. These include: the symmetry of external shocks; the degree of labour mobility, the degree of openness; and the extent of economic diversification. The more recent literature uses the same criteria to assess whether a country should fix or float its currency against currencies of countries in a specific optimal currency area. For example, if a country is relatively open in terms of trade to another or a currency bloc, but has no significant labour mobility, its economy is not well diversified, and it faces asymmetric shocks, a flexible exchange rate is likely to be a better choice for that country.

The intuition behind the optimum currency area criteria is that the real adjustment within an economy that has been hit by external shocks, usually takes time if nominal rigidities exist. The absence of labour mobility across borders rules out another adjustment mechanism. Thus, a flexible exchange rate would be the only automatic shock absorber that the country may rely on. Although Mundell did not discuss directly the other benefits of using fixed exchange rates such as minimizing transaction costs in trade (see below), he implied that if the cost of adjustment for a

country is not large, i.e. if the OCA criteria are met to some extent, it is better to choose a fixed exchange rate in order to get the benefit from the stability of the currency.

A more recent literature discusses another benefit of flexible exchange rates relying on the doctrine of the “impossible trinity”, which simply means the impossibility of having a fixed exchange rate, capital mobility and monetary independence at the same time (Frankel 1999). Under this doctrine, having a flexible exchange rate under the condition of high international capital mobility allows policy makers to conduct an independent monetary policy for domestic purposes. But if domestic authorities cannot make good use of the independence of monetary policies, it may be better to surrender this independence in order to import stability from other countries. Furthermore, other factors such as central bank independence, administrative capacity, depth and liquidity of foreign exchange markets can also influence the trade-off between monetary independence and exchange rate stability.

Theoretical models that try to formalize these ideas (e.g. Bayoumi 1994; Calvo 1999) generally confirm the intuition from the OCA and the impossible trinity literature. However, very often they have to use simplified assumptions and thus the results may be of limited usefulness when policy makers have to choose an exchange rate regime. And as Cohen (2000) put it “for every one of the characteristics conventionally stressed in OCA theory, there are contradictory historical examples - cases that conform to the expectations suggested by OCA theory and others that do not. None seems sufficient to explain observed outcomes. This is not to suggest that economic factors are therefore unimportant. Clearly they do matter insofar as they tend, through their impact on economic welfare, either to ease or exacerbate the challenge of sustaining a common currency. But equally clearly, more has gone on in each case than can be accounted for by such variables alone.”

Exogeneity or endogeneity of OCA criteria has also been in debate. Frankel and Rose (1998) argued that some criteria such as the synchronization of business cycles or trade relationships are endogenous. If this is true, an exchange rate peg and a common monetary policy can be self-validating such that countries pegging or fixing to another currency or joining a currency union will move closer to meet the OCA criteria by increasing intra-industry trade and correlating business cycles more closely.

Nevertheless, OCA criteria do matter if a country decides to tie its currency to an anchor, which may turn out to be an unsuitable one. In order to combat a history of hyperinflation and to constrain profligate economic policies, Argentina chose a currency board by tying its currency to the US Dollar. However, the US Dollar was the non-dominant anchor and without supporting fiscal policies by Argentina coupled with weak institutions, this decision proved disastrous given the weak trade links and business cycles which were out of step with the anchor. This then led to increased debt, lower investment and lower growth. Endogeneity, therefore, should not be taken for granted to work its magic if the political willingness to subordinate domestic policy objectives does not exist to maintain the currency peg and if the institutions are not in place to support such an exchange rate regime.

### **3.2 Fear of Floating**

The second concept, which has become popular in the recent literature on exchange rate regime choice, has been coined “fear of floating” (Calvo and Reinhart, 2002). There are two main explanations for the fear of floating hypothesis. First, exchange rate variability is one of the most prominent features of open economy macroeconomics and the tendency for nominal exchange rates to move so volatile and unpredictably has been blamed for limiting gains from trade and for lowering welfare. A desire to moderate this volatility has been a motivation behind the managed or fixed exchange rate regimes of many countries. Whether or

not a particular exchange rate regime has a significant impact on trade is still contested; empirical evidence points both ways if an effect is seen at all. Nevertheless, there is a widespread belief that exchange rate stability would significantly promote trade in particular for members of a currency union (Rose, 2000). Therefore, it is argued that the use of a fixed exchange rate helps emerging market countries to promote growth through high investment and saving.

The second explanation is euro-/dollarization of liabilities. Since most developing countries cannot borrow overseas in their own currencies<sup>2</sup>, most of their foreign liabilities are denominated in one of the major foreign currencies. Therefore, a sharp depreciation of their exchange rates would put severe pressure on the balance sheet of the financial and the corporate sector (Williamson 2000). Pegging the exchange rate to an anchor currency thus serves as an informal forward hedge, because of the huge flow of short-term dollar payments coming due, it is too risky to let the exchange rate move randomly.

For most EMCs the IMF advocates more flexible exchange rate regimes or at least advocates to chose an exit strategy if they have adopted an intermediate regime. Recent literature (Rogoff et. al, 2003) finds that the advantages of exchange rate flexibility increases as a country becomes more integrated into global capital markets and develops a sound financial system. Rogoff et al. find that free floats have, on average, registered faster growth than other regimes in advanced economies without incurring higher inflation. Developing countries with limited access to private external capital, pegs and other limited-flexibility arrangements have been associated with lower inflation, without an apparent cost in terms of lower growth or higher growth volatility. However, in EMCs with higher exposure to international capital flows, the more rigid regimes have had a higher incidence of crises.

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<sup>2</sup> This has been coined the 'original sin problem'.

The usefulness of flexible exchange rates as shock absorbers depends largely on the types of shocks hitting the economy and the exchange rate. Flexible exchange rates can generate rapid adjustment in international relative prices even when domestic prices adjust slowly. This makes them potentially useful absorbers of real shocks, which require an adjustment in relative prices in order to “switch expenditure” and cause output losses or overheating in the absence of price adjustment. A sudden drop in demand would, under flexible exchange rates, cause depreciation which crowds in extra demand.

On the other hand, the exchange rate adjustment in response to monetary and financial shocks leads to undesired changes in relative prices. In the case of a negative financial shock that puts upward pressures on interest rates, the exchange rate would appreciate, amplifying rather than dampening the negative impact on output. Under fixed exchange rates, in contrast, such a shock would be neutralized by an increase in liquidity stemming from a balance of payments surplus. Such asymmetric shocks would not occur in a currency union (Buiter and Grafe, 2002). Thus, the usefulness of flexible exchange rates declines as the relative importance of asymmetric monetary/financial shocks increases. If exchange rate changes do not generate an adjustment in international relative prices because pass-through to import prices is very small, the exchange rate is of little use as a shock absorber even in the case of asymmetric real shocks, though the empirical evidence remains supportive of the ability of the exchange rate to affect relative prices (Obstfeld, 2002).

If the two corner hypothesis is taken for granted, *in fine* many countries should choose to permanently lock in their exchange rates through currency boards or dollarization/euroization. Given the political unpalatability of dollarization/euroization along with significant policy constrictions which also afflicts currency boards, a currency union seems to be left as a practicable alternative. As will be further explored below, monetary unions are a serious long-term proposition for many regions but appear to be unfeasible in the short- to

medium-run largely owing to political problems. Therefore, more flexible or intermediate regimes with less emphasis on the exchange rate as a policy target can be stable provided that the exchange rate and domestic economic macroeconomic policies are determined in a mutually consistent manner.

#### *4 European experience*

EMU was a logical continuation of the Balassa sequencing: political sovereignty and economic interdependence often are in conflict. This conflict was resolved by creating a new supranational authority in the monetary and exchange rate domain. Problems and conflicts arise among states that, on the one hand, retain control of their national currencies and are able to pursue different monetary and exchange-rate policies and, on the other, have economies that are not only highly interdependent but are being reconstituted into a single internal market. Since economic interdependence was the objective, one remedy when policies conflict and either impose costs on others or impede the development and maintenance of the single market (or both), is to increase the congruence between the scope of political authority and the domain of economic activity. For states that are embedded in a densely institutionalized supranational organization, that in all likelihood means extending the domain of responsibility and institutional capacity of that organization.

This approach has remained largely unchanged since it was first implemented in the late 1960s. It is predicated on the assumptions that attainment of an internal market among the member-states requires stability among the currencies of the member-states, that currency instability can be eliminated by irrevocably fixing the exchange rates among the member-states' currencies, and that maintaining irrevocably fixed exchange rates permanently requires the creation of a common currency and an institution at the supranational level charged with conducting monetary policy.



The move towards monetary union in Europe involved several steps and was very often driven by political considerations. The Economic Community of Six agreed to eliminate all internal tariffs and to establish the first phase of common agricultural prices by July 1, 1968 (the Werner Plan). This reduced the ability of governments to affect, to their advantage, the prices of foreign-produced goods in domestic markets and thus would have made relative prices, and trade, dependent exclusively on costs, profits and exchange rates. Common prices of commodities would also require stable exchange rates since countries were highly sensitive to, and concerned about dampening fluctuations over time in the value of their currencies.

The Single European Act explicitly put EMU back on the agenda of the Community. An important decision was taken in June 1988 to remove all exchange controls that impeded the movement of capital by mid-1990. It created the possibility that capital could, in response to divergent economic performances, move across borders without restrictions. The result of that free movement was that central banks lost much of their ability to control exchange rates, possibly leading to greater variability of currencies, amplifying and exacerbating the volatility of exchange rates. The expected increased volatility of exchange rates was a serious threat to the internal market. The creation of Monetary Union and the European Central Bank enabled members to resolve these tensions and step down further on the road of integration.

The agreement to commence with Economic and Monetary Union can be explained politically by the commitment of member states to the ongoing process of European integration driven by France and Germany; by the recognition that the process of integration had acquired a life and a history of its own covering over 50 years and that individual governments were bound by the commitments of their predecessors; that none of the member-states wished to be left behind as the EU embarked on perhaps one of the most consequential institutional innovations in its history; and that even though the continued commitment to EMU and the

willingness to pursue policies to achieve the criteria of EMU that were at times costly in the end would serve their national interest. This then makes the European experience distinct from other regional integration processes observed today.

European Economic and Monetary Union has proved to be a credible and successful remedy to an enduring European problem – namely, how to create a single internal market for capital, goods and services among member-states with highly interdependent economies in a world with multiple currencies, volatile capital flows, and fragile exchange-rate regimes.

#### **4.1 Costs, Benefits and Long-Run Sustainability**

The European Monetary System in 1979 was largely founded in response to the high and rising inflation in the seventies and the demise of the Bretton Woods System of fixed exchange rates. The functioning of the ERM in an environment of stability-oriented policies, contributed to the convergence of inflation in the participating countries to that of Germany, the low-inflation anchor. In addition the commitment to maintaining fixed exchange rates with the DM reinforced the benefit of lower mean inflation and helped to speed up convergence once supported by consistent policies.

The Maastricht Treaty of 1991 specified the conditions, EU member states had to fulfill in order to be eligible for joining EMU. The requirements included the well-known macroeconomic convergence criteria and institutional requirements such as central bank independence.

These preconditions acted as a screening and commitment device such that governments showed their willingness to follow economic policies that did not impose costs on other members. Moreover, high nominal convergence was desirable to avoid large real exchange rate movements after the peg. The

experience of the ERM I showed that the path towards a common currency is fraught with difficulties. ERM I painfully made clear that the internal adaptability of some economies participating was insufficient or not credible for a smooth working of the peg. The periodic crises and the recurring need for realignments within the ERM demonstrate that transition arrangements towards a currency union are only sustainable when economic policies are largely subordinated to the maintenance of the agreed exchange rate bands. The fact that the EMU countries were able to attain that goal highlights their strong political commitment to it.

Countries considering participation in a currency union expect that such a move will entail efficiency gains owing to an elimination of transaction costs associated with converting different national currencies as well as the elimination of risk associated with the uncertainty of the price-development of exchange rates<sup>3</sup>. A reduction in transaction costs also increases price transparency, eliminates price discrimination which could increase competition. Since the study of Engel and Rogers (1995) on the border effect<sup>4</sup>, borders have been found to be very powerful in segmenting markets and for introducing large price differentials in addition to different national currencies. While the Euro has not eliminated the border effect per se, it may prompt further integration in other areas which will counteract the border effect.

Uncertainty about the future price of a currency translates into uncertainty about future prices of goods and services which could distort the allocation of resources. A decline in the uncertainty of the real exchange rate can reduce adjustment costs and the price system can send better signals. In addition, price uncertainty can lead to moral hazard and adverse selection. The former because an increase in the interest rate owing to price uncertainty changes the incentives for borrowers; the

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<sup>3</sup> For the Euro area the EC Commission estimated in 1990 that the gains of eliminating transaction costs could amount to EUR 13 to 20 billion per annum. Since these transaction costs are a deadweight loss, an improvement in welfare follows. These gains have increased with the elimination of fees for transfers within the Euro area which was caused by the setting up of the TARGET system.

<sup>4</sup> Engel and Rogers (1995) found that crossing the Canadian-US border was equivalent to travelling 2,500 miles within the same country such that price differences between neighbouring Detroit (USA) and Windsor (Canada) are as high as the ones between New York and Los Angeles.

latter because higher interest rates makes low-risk investment too expensive which in turn leads to an increase in the selection of more risky projects.

An elimination of exchange rate uncertainty may also increase economic growth. One channel is the real interest one which can cause an increase in the accumulation of capital and subsequently of the (temporary) growth rate<sup>5</sup>. Economic growth is further stimulated by the trade channel. Frankel and Rose (2000) found that a one percent increase in trade between countries of a currency union leads to an increase of per capita income of 1/3 of a percent. While their results have been widely contested and are at odds with similar literature that does not find an impact of exchange rate variability on trade<sup>6</sup>, other evidence points to growth effect for countries belonging to a currency union. This though could also be due to the standard endogeneity problem of currency unions. As Bacchante and van Wincoop recently stated, “(...) the substantial empirical literature examining the link between exchange-rate uncertainty and trade has not found a consistent relationship” (Frankel et al, 2000, p. 1093).

In one of the more recent studies on possible trade creation resulting from EMU, Farquhar (2004) finds that EMU has had a positive impact on intra-area trade. EMU increased trade among members by 10% since the advent of the euro. He also points to the fact that dynamic effects have been rising over time and are still increasing. But these gains are not evenly distributed: countries that have engaged predominantly in intra-industry trade within EU have seen their area trade flows grow faster. Gains in trade should also not be deemed as necessarily guaranteed: structural policies such as ease of sectoral reallocation and market entry help realize full potential of trade gains from monetary union<sup>7</sup>.

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<sup>5</sup> In a dynamic setting, the economy can even attain a permanently higher growth path.

<sup>6</sup> See IMF (2003) for new evidence that underscores the traditional findings. For criticism of the Rose methodology see for example Teneryo (2001).

<sup>7</sup> An additional benefit of a common currency is wrought by its increased use as an international currency. See for example Portes and Rey, 1998.

Fiscal rules<sup>8</sup> are based on political economy considerations. Public expenditure often is financed by debt issuance owing to inter-temporal redistribution considerations, thereby shifting the fiscal burden from today to the future. Fiscal rules are then an attempt to reign in the deficit bias of governments. They can act as a commitment device to prevent short-sighted political considerations leading to excessive spending and deficits and to limit discretionary fiscal policy. In a monetary union, undisciplined fiscal policies may impede a stability-oriented single monetary policy and would lead to negative spillovers.

The fiscal deficit and debt criteria which also form the cornerstone of the Stability and Growth Pact (SGP) were designed to ensure that countries were willing to bring their public finances onto a sustainable path. The aim was to avoid negative spillovers from the fiscal imbalances of individual member countries to other members through pressures for an undue relaxation of monetary policy or even a bailout of a government.

Fiscal rules are still an important issue for the long-run sustainability of a monetary union (Christl 2003; Hochreiter et al. 2003). Fiscal rules also matter because monetary union membership can give rise to moral hazard and free-rider problems: Moral hazard because a member country is expected to be bailed out by others when faced with unsustainable debt levels; free-riding because fiscal laxity in one country can drive up the union-wide interest rate and can induce others to relax fiscal rules.

Excessive deficits complicate monetary policy due to demand effects on prices and entail significant medium- and long-run costs such as higher real interest rates and tax burdens. Besides, political pressure could be exerted upon the central bank to

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<sup>8</sup> How potential fiscal rules should be designed is a contentious issue. Trade-offs to be considered encompass transparency and simplicity against flexibility. If a fiscal rule is very flexible it probably is less simple and transparent and loses credibility. However, simple and transparent fiscal rules tend to be too mechanistic to flexibly accommodate business cycles.

monetize government liabilities if the monetary authorities of a currency union are not sufficiently independent.

Since the market does not believe in the no-bail-out clause and, therefore, interest rate spreads are only a minor punishment for excessive deficits, fiscal rules are a necessary condition for a credible and successful monetary union. Therefore, rules such as the SGP are necessary to guard the culture of price stability and shift the focus of macroeconomic policies from domestic to currency-union-wide considerations. That's why ongoing discussions on a weakening of the SGP are not at all helpful in this respect.

## 4.2 Lessons so far

With the successful cash changeover, the euro has become a familiar notion. While skepticism proliferated before its introduction, the experience so far suggests that the euro can be judged to be a success.

Possible lessons for others that can be learned from the European experience include amongst other things:

- Monetary union is contingent upon the presence of monetary anchor currency with low inflation, strong economic integration and also on a strong political commitment focused on long-term gains.
- But political union is not at all a requirement ex ante.
- Outside factors such as systemic shocks and globalization can speed up the pooling of sovereignty in the economic domain.
- Convergence criteria are necessary and act as a screening and commitment device to guide expectations.

- To remain fully credible, a currency union requires policy coordination especially in the fiscal field coupled with an applicable enforcement mechanism as well as a forward-looking multilateral surveillance system.

## 5 Preconditions for closer monetary integration in other regions?

### 5.1 *Central and Eastern European Countries*

After the end of communism, former socialist economies faced the difficulty of transiting from command to market economies. The early goal of EU accession framed the policies of Central and Eastern European Countries (CEEC) that have recently joined the EU and gave them a rationale for pursuing a substantial reform and adjustment effort. The prospect of subsequently joining EMU provides a further anchor both for monetary policy but also for the ongoing structural and institutional reforms.

Geographic and cultural proximity to Western Europe and a swift liberalization of trade enabled CEECs to redress distortions inherited from central planning and reallocate trade flows away from other transition economies towards Western Europe<sup>9</sup>. A proper sequencing of macroeconomic stabilization and structural reforms in the financial sector enabled many countries to return to international capital markets and attracted foreign direct investment.

Probably the most important effect has been the institutional reform process set in motion by preparing for EMU. Institutional factors play a central role in determining a country's rate of economic growth<sup>10</sup>. Douglass North (1990) suggested that it is the incentive structure embedded in the institutional structure of countries that must be the key to solving the mystery of unequal and

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<sup>9</sup> Between 1993-95 the EU concluded bilateral Europe Agreements with the CEEC which established free trade areas covering most products. See also Jean-Jaques Hallaert (2003).

<sup>10</sup> Dysfunctional institutions limit a country's productivity and potential growth because potential losers from change can effectively block institutional change given their vested interests.

unpredictable economic growth. Indeed, institutional constraints that foster distortionary policies and worsen economic vulnerabilities account for a significant part of cross-country differences in economic growth and output volatility (see Acemoglu et. al., 2003). Institutional inertia could be punctuated by reforms required for the EU accession.

Previous enlargement rounds seem to have fostered an (endogenous) catch-up process of the joining countries leading to a reduction in the per capita income gap, a decrease in inflation, fiscal deficits as well as an increase in foreign direct investment and trade<sup>11</sup>. The prospect of joining the EU facilitated the adjustment of economic policies as well as the overhaul of institutions to meet requirements by the EU. But the prospect per se was not sufficient. Actual reform effort and implementation of policies were and are still required to bring about real as well as nominal convergence with existing EU members.

## 5.2 Latin America<sup>12</sup>

According to the Balassa-sequencing higher regional integration has two consequences: First, when regional integration leads from a free trade area to a single market, intra-regional exchange rate stability is of substantial importance to reap the benefits of such a move. Second, more exchange rate stability at the regional level can be expected, if at least the stability orientation of monetary policies of the countries involved converge.

The very high intra-regional exchange rate variability in Latin America has served as an impediment for the regional integration process<sup>13</sup>. The Brazilian and Argentinean crisis disrupted the integration process of Mercosur even further

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<sup>11</sup> See also IMF (2003) for a detailed analysis of the process of economic convergence of CEECs.

<sup>12</sup> This section draws on Dorrucchi et. al. (2003).

<sup>13</sup> The apparent increases in regional integration as witnessed by the rise in intra-regional trade is attributable to several factors such as the relative exchange rate stability between Argentina and Brazil during 1993 and 1998, IMF surveillance and programs that stressed inter alia an opening of economies and a relatively favourable world economic environment.



rather than spurring regional economic coordination and cooperation. No attempts were made to achieve nominal convergence given that nominal exchange rate variability exceeds the real one. This is also owing to the fact that a credible commitment to regional economic integration is so far has been missing.

Latin American countries follow two different though not mutually exclusive approaches to regional integration: (a) intra-regional arrangements such as Mercosur; (b) inter-regional arrangements like the Free Trade Area of the Americas (FTAA). Inter-regional arrangements probably limit countries to the establishment of free trade areas especially if one dominant partner rejects deepening of integration efforts. Intra-regional arrangements with the European experience in mind may benefit from deeper regional integration as a result of economies of scale, competition effects and improved resource allocation, which in turn could lead to a liberalisation of factor movements, policy harmonisation and policy coordination. Nevertheless, both options are viable ones and may or may not lead to a regional monetary arrangement.

Institutionally, Latin America is split into several sub-regional arrangements whose interdependencies are increasing only slowly. Mercosur has not taken on the role of engine for a consolidation of regional arrangements. Also, the supra-national element within Latin American regional arrangements is far less developed than within the EU. However, this proved to be instrumental in moving the European integration process further.

While Brazil is at first inspection the dominant Latin American country, it does not provide the region yet with a monetary anchor such as Germany did for the EU until 1998. Most Latin American countries are only now in the process of building-up credible monetary policies geared to price stability after decades of economic mismanagement and hyperinflation as well as institutions for the implementation for time consistent and credible policies, which is a time-consuming process. The

only countries which may be on the verge of achieving this seem to be Mexico or Chile. The latter is too small while the former is more involved in NAFTA.

Latin American countries follow nearly the entire spectrum of the exchange rate continuum, comprising managed and independent floating sometimes coupled with inflation targeting as well as dollarization. But none of the Latin American exchange rates has acquired an anchor role for neighbouring countries whereas European exchange rates before EMU were either floats or anchored with respect to the Deutsche Mark although a plethora of domestic monetary anchors existed (growth of money supply, interest rates, exchange rate). In addition, Latin American countries are subject to the third currency and interest rate phenomenon with the fluctuations of the USD and US interest rates still creating substantial problems for the region. The different exchange rate regimes employed in Latin America seem appropriate owing to the differences in income levels and (external) economic developments. A currency union therefore may not be appropriate for the time being as long as the third currency problem persists and economic conditions have not stabilized.

As a first step, the region may benefit from anchoring as a group to an outside currency such as the euro or US dollar. A basket including both the dollar and the euro may be beneficial since it is not clear which of the two main international currencies would provide the anchor for the region<sup>14</sup>. Alternatively, inflation targeting (see below) could create the conditions conducive to pursue first regional integration and second monetary integration in the medium- to long-term.

### 5.3 Asia

The Asian financial crisis of 1997-98 to a certain extent acted similarly as an exogenous shock to promote Asian monetary cooperation as the demise of the

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<sup>14</sup> South America trades with Europe to a large extent, and in many cases the business-cycle co-movements are as high with the euro area as with the United States.

Bretton Woods system of fixed exchange rates did for Europe. The main institutional arrangement became the Chiang Mai Initiative<sup>15</sup> agreed upon by the ASEAN plus 3 which mainly acts as a form of self-insurance in case of another financial crisis. Subsequently, a more significant step was the decision by the Executive's Meeting of East Asia-Pacific Central Banks (EMEAP) to set up the Asian Bond Fund (ABF) in dollar-denominated instruments in 2003. The ABF primarily aims at developing a regional bond market. The significance of this is twofold: in Europe monetary cooperation and ultimately currency union was supported and promoted by the respective European central banks. Second, the ABF creates an operational framework which should advance and focus monetary cooperation.

Yet, Asian regionalism has several characteristics that distinguish it from the EU. First, Asian regionalism is pluralistic. There is no single dominant organization that supplies continental regional integration in the manner of the EU. Membership of many of these organizations is often overlapping. This relates to the ambiguity in defining an economic region in Asia<sup>16</sup> which is owing to a lack of similarity in levels of development and lack of real convergence: as a general rule, the benefits of monetary integration are greater, and the costs lower, for countries which have similar levels of income and economic development. Asia is geographically quite disparate and there are significant differences in basic economic indicators which are narrowing only slowly.

Goals of the various regional Asian organizations are so far more modest than in the EU. APEC proposes to eliminate trade and investment barriers between its richer members by 2010 and by 2020 for its poorer members. It is no more than a

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<sup>15</sup> The Chiang Mai Initiative is basically a bilateral swap arrangement (BSA) facility for short-term liquidity assistance in the form of swaps of USD with the domestic currencies of participating countries. Countries drawing more than 10 percent are required to accept an IMF program. The BSA however is complementary to IMF financial assistance otherwise a regional surveillance system would be needed. IMF surveillance thus continues to be the main agency for monitoring economic developments in the region and serves as the institutional framework for policy dialogue and coordinating members and impose structural and policy reform on countries drawing facilities.

<sup>16</sup> Japan can be placed in a group of mature developed countries. Some countries belong to a high growth Asian group other exhibit more moderate growth. Hong Kong and Singapore form a group of their own as does China which was markedly different from the rest of Asia.

possible free trade area. Originally, ASEAN was not conceived as an economic community. Domestic resistance to free trade and liberalisation have managed to keep them largely off the organisation's agenda such that ASEAN is not a model of economic regionalism.

And not only is Asian regionalism a fairly recent phenomenon it also appears that the political will is lacking given that the 'natural' leadership role is contested: China, Japan and to a certain extent India are vying for a regional hegemon position. No country seems to act as the monetary anchor for the region<sup>17</sup>. In analogy to the EU experience, China and Japan probably have to go the same way of reconciliation that France and Germany have taken before any serious deepening of regionalism can be considered.

#### 5.4 General observations

Even though OCA criteria are met only to varying degrees in both regions, more regional integration should not be ruled out. But rather than looking at static OCA criteria, the political willingness supported by realistic objectives as well as regional economic conditions are instrumental whether regional integration will proceed further.

Obstacles exist that impede further regional integration in Latin America and Asia. If an increase in regional trade is the objective, this could be achieved with the right Balassa-sequencing. Some of the intra-regional arrangements are limited in membership similar to the initial EU of 6. Those could form a cluster for deepening trade relations leading to increased cooperation and policy coordination. In particular, the limited membership in Mercosur could make negotiations and co-ordination potentially easier if favourable economic circumstances arose, as happened in the early 1990s and if real convergence proceeds. Of particular

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<sup>17</sup> Although many other Asian countries could be said to have informally formed a Renimbi-zone with China as the anchor but in contrast to the European experience, the primary motivation for this is exchange rate stability and fear of loss of market share to China rather than attempts to integrate trade or have convergent prices or policies.

relevance will be the external environment: Negative external shocks leading to domestic macroeconomic instability have so far delayed regional integration in Latin America whereas they may have accelerated it in Asia though more in respect to regional monetary stability. Fear of an erosion of political sovereignty or domination by larger countries have hampered real integration efforts. Weak domestic institutions and policy inconsistency have failed to provide a credible basis for most integration efforts.

A regional surveillance mechanism and macro-economic co-operation would suit the need to strengthen nominal stability. Multilateral surveillance has especially helped former EU periphery countries to earn credibility, which transformed the ERM from an exchange rate arrangement into a convergence instrument. But already exchange rate co-operation could lower the magnitude of internal shocks produced by abrupt swings in the nominal exchange rate between the main Asian/Latin American currencies.

A monetary union may also play a role - especially for small open economies - in reducing the relative degree of trade openness, which may contribute to partly shielding the region from external shocks. Enhanced nominal stability and a lower relative degree of openness would help reducing the overall vulnerability. It could be easier to foster market-friendly reform in a regional framework than only within the global context. Finally, deeper integration could also be associated with political benefits such as stronger visibility and bargaining power in the international arena.

But also a non-Balassian approach to regional integration may be conceivable. The relative success of the EMU predecessors in stabilizing their bilateral exchange rates especially the nominal convergence achieved, suggests that exchange rate cooperation or soft exchange rate stabilization objectives, may set the stage for gradual integration. If business cycles are not too asymmetric, a common anchor could facilitate intra-regional exchange stability (Artis, 2002). Most Asians

countries have chosen the US Dollar or the Renimbi as an explicit or implicit anchor. While this move requires little cooperation, this has already lead to an increase in regional trade, thus reducing the relative degree of trade openness and shielding the region from external shocks. More stable exchange rates and lower trade openness would also reduce overall vulnerability.

## **6 Stability oriented macro-policies as an alternative?**

For the reasons mentioned before, for many countries or regions in the world forming a currency union is not a realistic goal in near future mainly owing to a lack of political will, lack of credible and consistent policies as well as the absence of dominant countries driving such a development. On the other hand, a prosperous development of the world economy needs fair and relatively stable exchange rates to stimulate world trade and the international division of labor. Exclusive policy reliance on the stability of the exchange rate with the exchanger rate entering the monetary authority's objective function directly has often not lead to the desired outcome of stable macroeconomic polices. A necessary precondition for such a development is stability oriented monetary and fiscal policies.

Traditional monetary policy frameworks to achieve low inflation and sustainable growth rested upon intermediate variables such as monetary aggregates to anchor expectations. This concept is often not suitable for EMCs mainly because of instable money demand functions. Targeting of the exchange rate as practiced to varying degrees in Latin America or Asia has not been successful Experience in some EMCs has shown that an explicit inflation target could provide a credible anchor for inflation expectations. Thus, inflation targeting (IT)<sup>18</sup> may be a successful strategy for larger EMCs to provide the macroeconomic stability desired

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<sup>18</sup> Monetary targeting tries to stabilize the inflation rate around the target value supposing a stable empirical relationship of the monetary target to the inflation rate and on its relationship to the instruments of monetary policy. Many emerging markets however have very instable money demand due to price shocks. With an exchange rate rule, monetary policy is constrained and cannot react to domestic or external shocks and in developing countries/EMCs the exchange rate itself can be a source of instability due to for example, real appreciation of the exchange rate (the Harrod-Balassa-Samuelsan effect).

and to have at the same time enough flexibility for coping with external shocks. Price stability and sound fiscal policy would clearly be preconditions for further monetary integration in future.

The quite successful experience with IT in a number of industrialized countries has increased the interest in this monetary policy framework also in emerging markets. Hungary, the Czech Republic, Poland, Brazil, Mexico, Thailand or Korea have already moved towards a direct or indirect form of IT.

Generally, IT requires that (a) the central bank is independent such that (b) it can commit to having low and stable inflation as the overriding objective of monetary policy, (c) the central bank announces a point or range target for the inflation rate and (d) clearly communicates and transparently details the instruments that will be used to achieve and maintain the inflation target.

IT could be useful in several aspects for EMCs. But the potential benefits are also closely linked to implementation issues that many EMCs have to address<sup>19</sup> in order to achieve sustained macroeconomic stabilization and growth.

- IT could be a helpful coordination device for inflation expectations;
- Since IT requires an independent and credible central bank, this could have positive externalities for the credibility of economic policy in general though it also could lead to tensions between the central bank and the government.
- If the rule guiding IT is kept sufficiently flexible, it would leave the central bank room for manoeuvre to address domestic as well as foreign shocks; and at the same time it can also focus the public on the real tasks of a central bank which is the control of prices rather than raising long-term growth.
- IT could help address the issue of fiscal dominance (i.e. high levels of government deficits and dependence on seigniorage) – which is relevant for any regime.

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<sup>19</sup> Operational issues such as whether to target a point or a range of inflation, the time horizon of inflation targeting and which measure of inflation to target are not considered here (see for example Bernanke et. al 1999)

- On the exchange rate inflation nexus Eichengreen (2001) suggests that the IT framework should be extended to account for the shocks that emerging economies are prone to. If EMCs are considering IT challenges are (i) forecasting of inflation in a volatile environment, (ii) liability dollarization/euroization which may affect the credibility of IT regime and could cause a conflict between different nominal anchors and (iii) the openness of the economy which will have implications for the exchange rate channel of monetary policy<sup>20</sup> and (iv) the degree of price indexation.

The experience of Brazil or Chile shows, that countries can make encouraging progress in reducing inflation and can gain credibility. Another benefit as pointed out by Bernanke et al. is that the framework is not an automatic Friedman-like rule but rests on constrained discretion: Chile and Brazil for example have implemented IT gradually and flexibly targeting a “long-run” inflation rate which removes temporary exchange rate effects. This has helped to reduce inflation without incurring substantial output costs<sup>21</sup>. Therefore, a case can be made for IT in EMCs to frame policy since policymakers will have to deepen financial and fiscal reform, enhance transparency and improve the fiscal stance, in addition to converging to international levels of inflation. Otherwise an inflation target could become non-credible with costs at least as large as the one from a non-credible exchange rate peg<sup>22</sup>. But as Mervyn King has observed: “inflation targeting should be viewed as a way of thinking about policy rather than as an automatic answer to all the difficult policy questions”. However

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<sup>20</sup> External shocks often cause strong exchange rate movements in EMCs which translate directly into inflationary pressures that may destabilize the economy. A central bank then may be unwilling to let the exchange rate move and will intervene in the forex market (fear of floating argument) such that the conflict between differing nominal anchors has to be addressed. In addition, explicit or implicit price indexation can lead to inflation inertia which could complicate IT implementation. In order to take account of the exchange rate, EMCs could use a monetary conditions index consisting of the interest rate and exchange rate. However, an MCI could have detrimental effects on employment and output.

<sup>21</sup> Though the experience of these and other countries could be subject to ‘mean reversion’.

<sup>22</sup> A necessary precondition for IT would have to be prior inflation reduction otherwise it will be difficult to publicly identify the target, which consequently will be missed, jeopardizing the central bank’s credibility. In addition, in the presence of high foreign currency liabilities, IT may lead to volatile exchange rates amplifying balance sheet effects.



IT probably should be accompanied by some fiscal policy rule with a view to constrain fiscal policy, discretionary intervention and thereby conferring credibility on the conduct of policy. Similar to the IT suggested for EMCs, these fiscal rules<sup>23</sup> will have to be a lot more discretionary than in developed countries owing to the inherent macroeconomic volatility and poor macroeconomic management. Fiscal rules in addition to IT would be important building stones of the economic institutional infrastructure; the former protecting fiscal discipline through time, the latter ensuring monetary discipline through time.

## 7 Conclusions

The successful completion of EMU and the introduction of the euro have substantially increased the general interest in regional integration and especially in regional monetary arrangements. The EU experience is not a blueprint for regional integration that can be applied directly and in its entirety to other regions. Unreflective comparison could therefore, lead to the dangerous trap of Euro-centrism.

It is tempting to see European regionalism and monetary union as a template or basic model because it is so long-standing; the EU has achieved incredible depth and has build up accompanying institutions. Most academic models of political and economic integration have so far been devised with Europe in mind or are drawing upon the European experience. The expectation then would be that 'orthodox' integration involves depth via a creation of a single market and/or monetary union as well as institutionalisation through the development of supranational institutions. But the European experience may not be the standard form integration has to take. Especially since European monetary integration did not itself proceed upon traditional lines, which postulates that monetary union is not possible or bound to fail without political union.

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<sup>23</sup> These fiscal rules could be limits on the government budget deficit, public borrowing or public debt and could be targeted at different levels of government, preferably with an effective sanctioning mechanism for non-compliance.

If institutional and economic integration were to proceed according to the European template, this would likely imply deeper monetary and exchange rate cooperation. However, the question of whether the political willingness and the other ex-ante requirements for deeper integration exist in other regions remains open to discussion. Discussion is therefore alive on longer-term options for respective exchange rate regimes such as joint anchoring to an outside currency or basket of currencies, the adoption of a common regional currency or floating against third currencies. However, the challenge more often seems to be whether credible institutions exist which will get the fundamentals right and which facilitate the implementation of consistent stability-oriented macroeconomic policies. While not a panacea, some regions depending on their overall macroeconomic strategy may be better served to introduce first an inflation-targeting regime accompanied by some fiscal rule rather than opting for a currency union.

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## **A Historical Perspective on the International Monetary System**

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We are celebrating the sixtieth anniversary of the United Nations Monetary and Economic Conference at Bretton Woods, New Hampshire. I should start by saying that Bretton Woods now carries a rather mixed connotation: some see it as a triumph of international cooperation and consensus building, while others judge it to be the source of an mistaken (restrictive) approach to international capital account movements.<sup>1</sup> It may of course have been both at the same time. Ten years ago, the positive elements were still emphasized rather more than the negative; today, perhaps largely as a result of widespread disillusion with instabilities produced by fixed exchange rate regimes, most commentators place their emphasis the other way round. Indeed in an influential book with Luigi Zingales, Raghuram Rajan, who subsequently became the IMF's chief economist, described Bretton Woods as a rather unhealthy compromise, which created in many countries an insulated "relationship capitalism" (that might be described as "crony capitalism") in which: "Productive firms that were not in political favor could not get finance. Capital controls also took away a significant source of budgetary discipline on governments, thus giving them leeway for constant intervention in the economy."<sup>2</sup>

In fact, Bretton Woods at the time was conspicuously incomplete: it was supposed to consist of three pillars, only two of which actually became reality, the International Monetary Fund and the World Bank. They were supposed to give concessions on the monetary side to the rest of the world, while the United States imposed trade liberalization through the third pillar, the International Trade Organization. But ITO was left until after the end of the World War, and was consequently stillborn.

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<sup>1</sup> I have presented both versions: the former in *International Monetary Cooperation Since Bretton Woods*, New York: Oxford University Press, 1995; the latter (with Michael Bordo) in "Haberler versus Nurkse: The Case for Floating Exchange Rates as an Alternative to Bretton Woods", in (ed.) Arie Arnon and Warren Young, *The Open Economy Macromodel: Past, Present and Future*, Boston: Kluwer, 2002, pp. 161-182.

<sup>2</sup> Raghuram G. Rajan & Luigi Zingales, *Saving capitalism from the capitalists : unleashing the power of financial markets to create wealth and spread opportunity*, New York : Crown Business, 2003, p. 243.

The world economy after the Second World War was rebuilt on the basis of systems of rules and complex institution-building, but only for some areas.<sup>3</sup> One way of thinking about the economic story is to regard rule-building in two critical areas as moving in different directions. During the interwar period, international discussions on international cooperation foundered because trade negotiators believed that while tariff reduction and quota elimination might be desirable, there was no point in discussions until a stable monetary system had been created. Without stable monetary order, the use of trade measures to stem the export of pernicious deflation could be justified as a desirable second-best measure. On the other hand, the monetary discussions foundered because of reluctance to make agreements while the vicious spiral of trade protection was still underway. During the Second World War, the U.S. made it clear that it was not prepared to negotiate on trade liberalization that it saw as necessary to postwar peace, and as a result, all the diplomacy concentrated on a framework of monetary rules (at Bretton Woods).

The rule-based monetary order disintegrated in stages between 1968 and 1973. The functions of the IMF, the major institution charged with policing the rules of Bretton Woods, changed very dramatically. Its major task turned out to be plugging market failures left by the newly invigorated capital markets: in practice a great deal of attempt at crisis prevention and a great deal of experience in crisis resolution.

A consensus gradually emerged for U.S. administrations that attempts at international monetary coordination were pointless and counter-productive: like the Bretton Woods order, they restrained monetary policy in a sub-optimal way and led to undesired outcomes. Thus the experience of the 1978 Bonn summit, or the 1985-87 negotiations and semi-agreements about appropriate exchange rates were generally viewed as discrediting the idea of negotiating about exchange rates. The mantra of all administrations since the 1980s is that exchange rates are set by the market.

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<sup>3</sup> The classic account of the postwar order is by Richard Gardner, *Sterling-dollar diplomacy; the origins and the prospects of our international economic order*, New York, McGraw-Hill, 1969. See now G. John Ikenberry, *After victory : institutions, strategic restraint, and the rebuilding of order after major wars*, Princeton: Princeton University Press, 2001.

On a global level, the rule-based system disintegrated, though there was a regional counter-movement in Europe. The moves to closer European monetary integration, with the elaboration of a system of rules at first very reminiscent of Bretton Woods, actually took place at moments of disillusion about the global scenario. Thus the European Monetary System was established in 1979, in the aftermath of the abortive Bonn summit; after the Plaza, the Europeans moved to agreed on principles for currency intervention for the EMS with the Basle-Nyborg agreement in 1987; and the final impetus to monetary union was given by the non-synchronous experience of recession in the U.S. and Europe in the early 1990s.

The postwar period produced a great expansion of trade that is fundamental to the story of increased prosperity. Trade became institutionally more regulated. The GATT generalized bilateral agreements, then produced general tariff reductions in the 1960s Kennedy round, and then became fully institutionalized as the WTO in 1996. Many observers are surprised by the apparent willingness of the U.S. to accept rules in this area at each stage of the development of a rule-based order. The story of trade opening can be read as a suspense drama, with a new twist to the narrative on almost every page. The GATT was a compromise. It achieved its biggest successes in the 1960s, largely at the cost of reducing its extent so as to exclude some of the most contentious trade items - textiles and agricultural products. By the 1970s, after the collapse of the Bretton Woods par value system, most writers agreed that the GATT was moribund. The Tokyo Round was protracted and spotty. In the mid-1980s, the leading experts concluded that the GATT was "in a state of breakdown". The ministerial meeting of 1982 had failed. The Uruguay Round looked doomed to failure as the United States and the European Community became locked in a politically complex struggle over agricultural pricing and subsidies. Even in 1993, on the eve of the final agreement of this Round, a major text produced by a GATT official had as its theme "the weakening of a multilateral approach to trade relations", "the creeping demise of GATT", and the fact that "the GATT's decline results from the accumulated actions of governments."<sup>4</sup> But then came the astonishing extension of multilateral principles to intellectual property, trade-related investment, and

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<sup>4</sup> Patrick Low, *Trading Free: The GATT and U.S. Trade Policy*, New York: Twentieth Century Fund Press, 1995, p. 247.



the creation of a more complete conflict resolutions procedure and the institutionalization of multilateralism in the World Trade Organization. At that time, the commentators were skeptically insisting that the United States would ignore the new institution, and instead continue a unilateral exercise of power through the application of Super 301. But when the first ruling came against the U.S., the U.S. accepted it. In 1998, everyone gave reasons why the financial services agreement could not be realized. Then, apparently unpredictably, at the last moment it came about. The U.S. steel tariffs would destroy the WTO, but then the U.S. gave in. Rules still ruled.

How can we explain this development toward rules in trade and away in the monetary domain? In the nineteenth century era of globalization, there were no mechanisms for agreeing international rules on either trade or money: this was a decision for nation-states. There were plenty of other international agreements: on weights, standards, postal systems, the treatment of POWs, the International Red Cross. The one attempt to provide a common monetary standard, the International Monetary Conference summoned by Napoleon III in 1867, was a miserable failure.

In the earlier age of worries about globalization at the turn of the nineteenth century, a backlash began. The nation-state appeared as a protective carapace against the ills flowing from global integration, and in the end evolved restrictions on migration and high levels of trade protection. When national protection became the major priority of most countries, in the 1920s and 1930s, the world became both poorer and less safe. There was a vicious cycle, in which external forces were blamed for loss and disaster, and high levels of trade protection destroyed national prosperity.

It was in response to this failure that the need for international agreement on a framework of rules for international integration became apparent. Rules on trade were designed to lock in solutions to Olsonian collective action problems: to the tendency of powerfully articulated particular interests (for protection) to assert their primacy over a much less forcefully developed sense of a general good lying in trade opening.

Monetary questions by contrast are much less vulnerable to capture by particularistic rent-seeking interests. The monetary rules of Bretton Woods were not devised to solve collective action issues *within* countries, but rather to deal with coordination problems *between* countries. They followed from the articulation of

conflicting national strategies: in particular, the fixed exchange rate regime was generally explained by the need to prevent nations indulging in competitive “beggar thy neighbor” devaluations of the kind that had occurred in some instances in the 1930s (notably in Japan after 1931).

Most countries have avoided the interwar sort of backlash in the second half of the twentieth century, although their citizens had the same angst. The changing of employment patterns is a constant accompaniment of growth. In the early 1970s and again in the 1980s U.S. workers and producers were upset about the loss of jobs to Japan. Some of the most skilled jobs, in automobiles, were lost; household appliances like TVs were no longer made in the United States. On each occasion, the administration tried to respond to the job loss worries not by trade restrictions, but by exchange rate alterations that would make the U.S. products more competitive, in other words by a kind of echo of 1930s style solutions: first the end of the gold convertibility of the dollar in 1971, and then in 1985 the Plaza agreement to depreciate the dollar. Monetary and exchange rate policy initiatives offered a way of absorbing adjustment pain. The focus of trade discontent was shifted to the monetary arena in a way that helped to undermine the legitimacy of institutional ways of regulating the international financial system.

The use of monetary policy and exchange rate adjustment to deescalate trade conflict is harder today, since many of the countries whose products are entering the United States either formally or informally peg their own currencies to the dollar. (Japan, notably, is classified by the IMF as having an “independent float” but in practice has a vision of where its exchange rate should be.) In practice, over half of the world’s population and over half of the world economy is more or less informally associated in a sort of Bretton Woods system, but without the rules for behavior and adjustment of the original order.<sup>5</sup>

Governments still feel that they need some response in an attempt to “feel the pain”, and to show that they are doing something. Like the Bush administration they

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<sup>5</sup> Especially Michael P. Dooley, David Folkerts-Landau, Peter Garber, *An Essay on the Revived Bretton Woods System*, NBER WP 9971, Sep 2003. The lessons are drawn in Martin Wolf, “Why the Fed is forced to fuel a global boom”, *Financial Times*, March 31, 2004. See also the recent critique of Barry Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, NBER WP 10497, May 2004.

adopt tariffs that may then be over-ruled by the WTO. In this way they do nothing very harmful, but point out to the electorate that their hands are tied by international agreements and institutions. But this sort of action itself then produces a new kind of backlash, against the international institutions.

Trade problems were in fact in the post-1945 world routinely dealt with by shifting the emphasis to the monetary arena. The world has developed its institutional arrangements in the setting of globalization by making them harder in the trade arena and softer in the monetary one. In the future the offloading of adjustment problems to monetary policy will be more difficult (because of widespread Asian exchange rate pegging) and the trade system will be in consequence more vulnerable.

## II

The key element of the Bretton Woods system, which allowed the formulation of the rules, was the widespread consensus on the desirability of controlling and restricting the movement of capital. Conversely, the major development which is usually held to require movement to a floating rate system is the development of large international capital flows. Since 1990s, these have become more extensive, but also more various: they are no longer limited to bank credits mostly to public sector borrowers, but involved portfolio investment and FDI. From the standpoint of capital flows, the world can be split into three groups: at the ends of the spectrum, there are on the one side well developed industrial economies, and on the other poor economies, in which capital inflows play no substantial role. In between, there is a group of countries with rapid growth and good prospects for the future, but a limited capacity to borrow (what Reinhart and Rogoff have diagnosed as a “debt intolerance”) and no ability to develop long term markets in their own currencies.<sup>6</sup> These economies are vulnerable to crises of confidence.

Deep capital markets and well-developed financial institutions are generally recognized as a prerequisite for opening to international capital flows. But it is clear that

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<sup>6</sup> Carmen M. Reinhart, Kenneth S. Rogoff, Miguel A. Savastano, *Debt Intolerance*, NBER WP 9908 Aug 2003.

many countries with strong chances of impressive economic growth do not have such institutions, and are consequently very vulnerable to financial crises as capital flows are abruptly reversed. Indeed in the wake of the 1997-8 Asia crisis, there is almost a new consensus on emerging markets that the price that is paid for premature capital account liberalization is too high.

This view may be too cautious: some very successful economies grew dynamically, but with repeated interruption by severe financial turbulence. This was the case with the United States in the later nineteenth century, where there existed a very dynamic instability, but also of Korea since the early 1960s. Repeated crises, in the mid-1970s, in 1982, and then again in 1997-8, were accompanied by reform, a reorientation of economic policy priorities, and a new type of growth. Chile's path to reform and economic opening was also marked a major crisis in 1982-3.

But there are two caveats: first, widespread contagion is obviously damaging on the world level and has at some moments, notably 1982 and 1998, threatened the global financial system. Secondly, even in an isolated national context, financial crises can be deeply destabilizing, especially in conditions where there is inadequate political stability. As a consequence, the policy debate has shifted from a narrower concern with purely financial measures to a much broader concern with institutional and political capacity: measures of corruption, the relation of the central government to provincial authorities, capacity for enforcement, transparency of the financial and economic system. The consequence is that it is useful to think of mechanisms to enhance stability of "emerging markets" – where markets and political institutions are not yet very deep.

### III

The substitution of international mechanisms as credibility or commitment devices in place of absent deep domestic markets may offer a role for the IMF, but it is a very difficult and problematic one.<sup>7</sup> Conditionality can be described as a way of lending not only money but credibility through effective policy reform. Keynes's original vision

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<sup>7</sup> See Ashoka Mody and Diego Saravia, "Catalyzing Capital Flows: Do IMF-Supported Programs Work as Commitment Devices?", IMF Working Paper No. 03/100, May 1, 2003.

for Bretton Woods did not need this, since there were no capital flows; and he wanted in consequence an entirely automatic Fund, in which financial resources would simply be made available as in a sort of blind credit cooperative. But Keynes was over-ruled on this.

At first, the idea of policy reform was relatively simple, but it has become increasingly wide and complex. The problems involved in the linking of lending with conditionality and policy reform are not unique to the IMF's operations. They are inherent in any attempt to subject lending to conditionality. The League of Nations programs for Hungary and Austria in 1922 and 1923, for instance, raised exactly the same issue, and the criticisms of them as excessively harsh and intrusive on national sovereignty precisely prefigure later debates. The external control imposed on politically fragile states emerging out of the postwar breakup of the multinational Habsburg Empire was so extensive and tough that it constituted a deterrent to embarking on similar programs in other states. Instead, countries attempting to stabilize their currencies in the mid-1920s turned to the less "political" capital markets, with the result that, as a general principle, the League's conditionality was counterproductive. A reaction against the experience of the League made some of the architects of the Bretton Woods system, particularly John Maynard Keynes, desire a more automatic Fund. But the principle of conditionality—Keynes called it in a memorable phrase "being grandmotherly"—soon reasserted itself in the lending of the new institution.

For the IMF, conditionality became an increasingly sensitive issue in the 1960s and, above all, in the 1970s for the following reasons. First, because quotas were not raised in line with the dramatic expansion of world trade, higher levels of lending in relation to quotas were required, with consequently increased conditionality. At this time, there was a very strict view that conditionality should be proportional to the extent of quota borrowing, with every tougher measure required as quotas were exceeded. Second, the expansion of capital markets, which had been completely unanticipated at the time of the Bretton Woods conference of 1944, offered an alternative source of capital. The result was that conditionality applied only to some debtor countries, and the concept of countries "graduating from" the IMF became increasingly popular. Here, however, the skittishness of markets soon produced some unpleasant surprises. Before the outbreak of

the 1982 debt crisis, many finance ministers and bankers had considerable confidence that the IMF was irrelevant to all except the poorest countries. Similar beliefs gripped the markets before the 1997 outbreak of the Asian crisis. Third, conditionality became more complex in order to avoid unintended consequences in programs. Previously, for instance, because of the pressure exerted by powerful political and civil service lobbies, fiscal conditions had often led to big cuts in government investment but very little reduction in government consumption. As a result, economic prospects worsened. Programs therefore began to specify elements in public spending—public sector pay guidelines, investment levels, and the like. Such an expansion of activities inevitably brought the IMF into the political domain.

The big capital account crises of the 1990s involved much larger amounts of support relative to previous crises. Mexico in 1995 drew 688 percent of its quota, Korea in 1997-8 139 percent, Argentina in 2001 800 percent, and Turkey in 2002 1330 percent. Before the 1990s, there had been an inclination to give too little in order to give incentives to program countries to make adjustment and reforms. When the emphasis shifted to reassuring nervous markets in a capital account crisis, the priorities were reversed, and stabilizing the expectations of the markets would involve the assurance of so much support that speculators could not take a position against a country or currency and hope to succeed. This function had an analogy to the role of central banks in national economies as lenders of last resort, an analogy that was controversially drawn by the IMF's FMD Stanley Fischer. The parallel is sometimes made to the Colin Powell doctrine about military intervention: that it only makes sense if conducted with massive force.

The aftermath of the big bailouts in the 1990s is acutely controversial. The immediate criticism, which was probably overstated, was that it produced a moral hazard problem. In the view of Milton Friedman, for instance, the 1995 Mexican program produced the Asian crisis of 1997 because investors assumed a Fund guarantee. This may have been some part of investors' calculations, but they were fundamentally impressed by the idea of an "East Asian miracle" that they should buy into. There is an analogy with the development of the stock market boom in industrial countries the late 1990s: some of it may have been driven by the idea that central banks (and in particular

the Federal Reserve) would support a certain level of the market, but mostly it was driven by a vision of a “New Economy”.

The real problem came from the size of the rescue operations, the strain that these brought for the IMF’s resources, the fact that as a result such operations could not be envisaged for a large number of countries simultaneously. In particular in 1998 after the Russian crisis the realistic belief that the Fund was near to the end of its resources increased fears of a generally contagious crisis. The conflict between a aim of massive response and the limited financial capacity of the IMF brought an element of intellectual incoherence to the whole approach, that was particularly visible in the stance of the United States. Paul O’Neill as Treasury Secretary repeatedly attacked the idea of “big bailouts” in principle, but then went on to advocate them very forcefully in particular cases, often in the face of resistance from other G-7 countries who wanted to interpret them as political opportunism.

In the 1990s, this view of the IMF and its role changed dramatically. In large part, this was a consequence of reflections on the collapse of communism and on the links between political and economic reform. In the 1980s, many political scientists believed that economic reform was more easily achieved by authoritarian regimes. The experience of Central Europe, in particular, completely reversed the general understanding of the link between economic liberalization and political democratization. In the new picture, only a country whose government was sustained by a deep reserve of legitimacy would be able to bear the pains associated with adjustment.

This change had repercussions for the concept of conditionality. If there was less room for a benevolent authority in imposing economic reform, this would also mean questioning the traditional role assigned to the IMF. Instead, the issue of "ownership" became central.

The collapse of the centrally planned economies or (in the case of China) their movement toward the market was the last stage in creating a new consensus about economic policy, frequently but misleadingly referred to (in a phrase coined by John Williamson) as the "Washington consensus." The consequence has been an increasing homogeneity of political outlook, as well as of the economic order. Indeed, one key

insight is that the two are linked: that economic efficiency depends on a functioning civil society, on the rule of law, and on respect for private property.

The post-cold war world has a quite different politics. There is no longer a lineup of East versus West, in which pro-Western regimes automatically obtain support, regardless of their levels of efficiency and competence and probity. Rather, the international community is adopting a much more interventionist stance in which the logic that associates economic and political change is taken more seriously. The result has been the forcing of a much quicker pace of economic reform in some countries (for example, Egypt, which until the early 1990s largely resisted attempts to liberalize); the disintegration of the political order in others (the collapse and defeat of Mobutu's Zaïre); and the descent into the status of international pariah for others. The striking change in this area is that there is no longer an acceptance of domestic political inefficiency, corruption, or oppression.

The most visible product of the new political environment of the 1990s is the concern of the Bretton Woods institutions with "governance." In August 1997, a new set of guidelines promulgated by the IMF's Executive Board instructed the staff that, in policy advice, the IMF "has assisted its member countries in creating systems that limit the scope for ad hoc decision making, for rent seeking, for undesirable preferential treatment of individuals or organizations." The IMF suggested that "it is legitimate to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation." At the same time, these guidelines also preserved the nonpolitical vision of Bretton Woods, requiring the IMF's judgments not to be influenced "by the nature of the political regime of a country." In particular, recognizing an obvious danger, they specify that "the IMF should not act on behalf of a member country in influencing another country's political orientation or behavior."

The IMF's interest in governance was already reflected in a number of very high profile decisions in 1996-97. Conditionality has come to the fore in each of four completely new areas. First, military spending had never been a topic of explicit discussion by the IMF in the era of the cold war. For instance, in the early 1980s, in the context of a discussion of a large IMF program with India, the DMD stated that the discussion of military spending had to be avoided, in that this was an issue which touched



on the core of sovereignty. Since 1993, however, it has been discussed in the IMF's *World Economic Outlook* reports as a major problem of misallocation of resources. In a number of cases, notably those of Pakistan and Romania, it became a central element in IMF discussions. Second, corruption is explicitly addressed: in Africa, but also in Indonesia. Third, so also is democracy addressed, although there is no reference to democracy in the IMF's Articles of Agreement (unlike those of the European Bank for Reconstruction and Development). Fourth, especially in response to the Asian crisis, a critique developed of a feature that had previously been regarded as a linchpin of Asia's economic success—the concept of "trust," or of "strong informal networks"—and that was now relabeled and condemned as "crony capitalism." This criticism was linked to the attack on corruption, and "a stable and transparent regulatory environment for private sector activity" was laid out as the solution.

There had been some consideration of human rights issues in the past: in Poland, whose membership application was held up in the 1980s after the imposition of martial law and the internment of political dissenters; or, more discreetly and subtly, in South Africa in the 1980s, where apartheid was attacked as an inefficient labor practice. But the scale of the discussion of political issues in the mid- and late 1990s is novel. To take an example: there was no discussion of political issues in Article IV consultations with Indonesia until June 1997, when these issues suddenly appear and are addressed quite directly as a need for political reform. The extension of the IMF into these areas is an immediate result of the new consensus about economic practice and of a new world political order that it has helped to produce. But it reflects something more profound—a realization increasingly shared throughout the world that the world economy, and world institutions, can be a better guarantee of rights and of prosperity than some governments, which may be corrupt, rent-seeking, and militaristic. Economic reform and the removal of corrupt governments are preconditions both for the effective operation of markets and for greater social justice. Indeed, these two results, far from being contradictory as some critics imagine, are complementary.

The new approach may produce greater global prosperity and stability. By helping to provide markets with better information, ensuring greater transparency, and limiting the irrational destructiveness of financial crises, the IMF can help markets operate more

efficiently. But questions arise concerning the degree to which the IMF can be "evenhanded" in its treatment of all its members.

First, one of the most fundamental issues is the political counterpart to the criticism expressed by Paul Volcker, former Chairman of the U.S. Federal Reserve System, of IMF economic programs: "When the Fund consults with a poor and weak country, the country gets in line. When it consults with a big and strong country, the Fund gets in line. When the big countries are in conflict, the Fund gets out of the line of fire." Addressing the issues of military expenditure, corruption, and undemocratic practices is easier for international institutions in the cases of small countries, or even politically isolated countries. But it is likely to be hard and controversial in large states with substantial military and economic potential—for instance, China or Russia. Discussion of such issues inevitably plays a major role in domestic politics. In Russia, this kind of criticism of international institutions has made most effectively by liberal opposition politicians such as notably Grigory Yavlinsky. They explain the problems and failures of Russian reform programs by an unwillingness of the international community to go far enough in attacking corruption and in imposing reform from the outside. In other cases, conditionality will be interpreted as a blatant attempt to impose Western values in the hope of restraining or even crippling potential competitors (a criticism frequently voiced, for example, by Mahathir Mohamad, the former Prime Minister of Malaysia).

Second, the IMF's financial capacity is limited. The amount of money involved means that only a very few big crises can be dealt with at a time. This was the near panic fear of 1998. We are clearly not yet out of the woods on this issue. Indeed it is possible to imagine in the future a program with China that could not be dealt with by an institution of the present size of the IMF. With that, the institution would be back to the dilemma of interwar institutions, such as the League of Nations or the Bank for International Settlements, that attempted policy advice and stabilization but simply did not have the resources in the face of market panic.

Third, there is also the question of the IMF's institutional capacity for implementation. Some recent programs and statements also go into such issues of economic organization as the dismantling of cartels, the improvement of accounting practices, and banking supervision. On the one hand, it is easy to see the macroeconomic

effects of the organizational or structural flaws criticized by the IMF. On the other hand, correcting them takes the IMF into completely new areas in which it has no previous experience. It is clearly experienced in fiscal affairs and in advising on central bank policy, but not in wide-ranging reforms of the financial sector or in accountancy. The detailed reorganization of corporate balance sheets in order to ensure greater transparency—which is incidentally also a problem in many industrial countries—is a less appropriate task for international institutions than for private sector consultants and accountants. The gains, after all, will directly benefit the companies undertaking the reforms.

Fourth, and most fundamentally, this process of adding new expectations could create a dangerous momentum of its own. Part of the discussion of the late 1990s in the U.S. Congress on an IMF quota increase involved the issue of whether to integrate environmental and labor standards into IMF programs. Congressional conservatives wanted to add clauses restricting the use of public funding (that might be held to derive from IMF loans) for abortion. Many of the IMF's member countries rightly feel that economic reform programs must be responsive to social and humanitarian concerns. But the amplitude of such an agenda may produce an expectations trap. The more the IMF is seen to extend its mandate, the more it will be expected to undertake, and, inevitably, the greater the challenge it will face in trying to live up to the demands. This is largely what happened in the 1990s: with financial globalization, the IMF seemed to be on the one hand more powerful, and on the other hand less capable of influencing events.

The IMF after 1998 clearly recognized the need to resist institutional overstretch: to ensure that its mandate is limited, clearly defined, and subject to realistic assessment of results. The review of conditionality in 2002 tried to adopt a more flexible approach, and to play up the element of country “ownership”, i.e. political responsibility for the formulation of effective policy response. But it is important to recognize that the mission creep of the 1990s was not simply the result of a bureaucratic power drive, but reflected a real difficulty in designing appropriate and credible institutions in a world in which capital moved more freely.

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The problems raised by the new mobility of capital, that Bretton Woods had intended to constrain, are not capable of being simply dealt with by the adoption of a new framework of rules or laws. In that sense, Bretton Woods cannot really be reinvented; and the analogy with the trade area, which is appropriately the domain of international law-making is not correct. But the problems are certainly real, and demand a considerable extent of institution building. This is a complex process, and not always easily done from the outside or on a global scale. Above all, it requires the elaboration of generally applicable rules if it is to be legitimate, rather than case by case interventions, which may foster discontent and resentment. Let me conclude on an Austrian note. Thinking back to the circumstances of 1944, a work which John Maynard Keynes read on his way to Atlantic City and Bretton Woods, contains some useful advice. In *The Road to Serfdom*, F.A. Hayek wrote:

“Though there are no doubt many people who honestly believe that if they were allowed to handle the job they would be able to settle all these problems justly and impartially, and who would be genuinely surprised to find suspicion and hatred turning against them, they would probably be the first to apply force when those whom they mean to benefit prove recalcitrant, and to show themselves quite ruthless in coercing people in what is supposed to be their own interests. What these dangerous idealists do not see is that where the assumption of a moral responsibility involves that one’s own moral views should by force be made to prevail over those dominant in other communities, the assumption of such responsibility may place one in a position in which it becomes impossible to act morally. To impose such an impossible moral task on the victorious nations is a certain way morally to corrupt and discredit them.” (p. 169)



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1) vergriffen (out of print)

2) In abgeänderter Form erschienen in Berichte und Studien Nr. 4/1990, S 74 ff

3) In abgeänderter Form erschienen in Berichte und Studien Nr. 4/1991, S 44 ff

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