UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNITED NATIONS

CENTER FOR
INTERNATIONAL
DEVELOPMENT
HARVARD UNIVERSITY

G-24 Discussion Paper Series

Exchange-rate Policies for Developing Countries: What Have We Learned? What Do We Still Not Know?

Andrés Velasco

No. 5, June 2000

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

CENTER FOR INTERNATIONAL DEVELOPMENT HARVARD UNIVERSITY

G-24 Discussion Paper Series

Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs

UNITED NATIONS
New York and Geneva, June 2000

Note

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

*

* *

The views expressed in this Series are those of the authors and do not necessarily reflect the views of the UNCTAD secretariat. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

*

* *

Material in this publication may be freely quoted; acknowledgement, however, is requested (including reference to the document number). It would be appreciated if a copy of the publication containing the quotation were sent to the Editorial Assistant, Macroeconomic and Development Policies Branch, Division on Globalization and Development Strategies, UNCTAD, Palais des Nations, CH-1211 Geneva 10.

UNCTAD/GDS/MDPB/G24/5

UNITED NATIONS PUBLICATION

PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising the awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

EXCHANGE-RATE POLICIES FOR DEVELOPING COUNTRIES: WHAT HAVE WE LEARNED? WHAT DO WE STILL NOT KNOW?

Andrés Velasco

New York University,
University of Chile and
National Bureau of Economic Research

G-24 Discussion Paper No. 5

June 2000

Abstract

The 1997–1998 Asian crisis, with its offshoots in Eastern Europe and Latin America, has reignited the debate about appropriate exchange-rate policies for developing countries. One widely shared conclusion from this episode is that adjustable or crawling pegs are extremely fragile in a world of volatile capital movements. The pressure resulting from massive capital flow reversals and weakened domestic financial systems was too strong even for countries that followed sound macroeconomic policies and had large stocks of reserves. As a consequence, the polar regimes of a "hard pegs" (such as a currency board), or a clean float, are enjoying new popularity.

This paper argues that, while currency boards or even dollarization may be justified in some extreme cases, they are not appropriate for all developing countries. The recommendations formulated on the basis of the Mundell-McKinnon criteria for the optimum currency are considered still sensible today. Currency boards face serious implementation problems. One is the choice of the currency to peg to and at what rate; another is the need to ensure stability of the domestic financial system in the absence of a domestic lender of last resort.

Floating appears to have wider applicability. As Friedman already argued in the early 1950s, if prices move slowly, it is both faster and less costly to move the nominal exchange rate in response to a shock that requires an adjustment in the real exchange rate. But for exchange-rate flexibility to be stabilizing, it has to be implemented by independent central banks whose commitment to low inflation is credible. Ongoing depreciations that follow from imprudent of opportunistic monetary behaviour will surely come to be expected by agents, and hence will have no real effect; occasional depreciations that respond exclusively to unforecastable shocks will, almost by definition, have real effects. But floating also faces questions of implementation. Given that no central bank completely abstains from intervention in currency markets, what principles should govern such intervention? The paper elaborates on a number of points in this regard on which recent experience is likely to be instructive, but on which more research is needed.

Finally, any exchange-rate regime, and especially one of flexible rates, requires complementary policies to increase its chances of success. In this context, some have suggested the use of capital controls; less controversial is the need for prudential regulation of the financial system and for counter-cyclical fiscal policy.

Table of contents

Page

EXCHANGE-RATE POLICIES FOR DEVELOPING COUNTRIES: WHAT HAVE WE LEARNED? WHAT DO WE STILL NOT KNOW?*

Andrés Velasco

I. The new conventional wisdom

The 1997–1998 Asian crisis, with its offshoots in Eastern Europe and South America, revealed how little we still know about workable exchange-rate policies for developing countries. Arrangements that had performed relatively well for years (think of Indonesia and the Republic of Korea) came crashing down with almost no advance notice; other arrangements that once seemed invulnerable (think of Hong Kong's currency board) almost tumbled down as well. Mid-course corrections and policy changes proved equally troublesome: in every country that abandoned a peg and floated (Brazil, Ecuador, Russian Federation and Thailand, and again Indonesia and Republic of Korea) the exchange rate overshot massively, and a period of currency turmoil followed. And all of it, of course, with tremendous real costs: both the high interest rates used to defend pegs and the massive depreciations that followed abandonment played

lessons, no tenet of conventional wisdom is more pervasive than the "law of the excluded middle": there is apparently no intermediate exchange-rate regime suitable for developing countries. Currency boards or free floating are, allegedly, the only options.

The reasoning behind this fashionable conclusion is simple. Adjustable or crawling pegs were in place in almost every country that recently experienced serious difficulties: Brazil, Ecuador, Indonesia, Republic of Korea, Russian Federation and Thailand. The pressure brought by massive capital flow reversals and weakened domestic financial systems was too much to bear, even for countries that followed reasonably sound macro policies and had seemingly plentiful reserves.

If lack of credibility and the resulting endemically high interest rates was one of the factors that brought these pegs down, the logic goes, then the answer is to ensure credibility at any expense: "hard