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What is the right exchange rate regime?

This is not the first time in the last quarter century that the general question of what to do about exchange rates has arisen. Indeed, the question has been a recurring one. Those of us with long memories, or who have studied the economic history of Latin America, will remember that in the 1960s the great hope was the crawling peg. Chile, then Brazil, and then Colombia adopted crawling pegs in the belief that, by gradually adjusting the nominal exchange rate over time to account for inflation differentials, one could dispense with worrying about having higher inflation than in the industrial countries. The idea was fashionable for a while but was eventually shown not to be a very good one, and it went out of fashion.

Not the hope of the '60s - the crawling peg ...

... nor the fashion of the '70s - the fixed exchange ...

In the 1970s there was great interest, which in some quarters amounted to an obsession, with fixed exchange rates. Fixed rates were claimed to have a powerful disciplinary effect, endowing countries that adopted them with greater credibility. The countries of the Southern Cone adopted the famous-or infamous-tablitas, or preannounced crawling pegs, and went from there to a fixed exchange rate. This did not last long, however, before a major crisis occurred, which in retrospect looked much like the tequila crisis of 1994-95 and the Southeast Asian crisis of a few years later.

...nor the currency bands and managed floats of the '80 and the fixed regimes of the '90s.

The 1980s were the era of currency bands and managed floats. In the early 1990s we rediscovered fixed exchange rates, although not yet of the "hard fixed" kind. People looked with great enthusiasm and admiration at the Mexican experience, with its solidarity pacts, which embodied the notion that one can combine a fixed exchange rate with incomes policies. Then came December 1994 and the realization that this was not the answer either.

Today, the interest lies in superfixed exchange rates.

One of the lessons of the tequila crisis, later reaffirmed by the Asian crisis, was that so-called fixed but adjustable exchange rates can be dangerous, and that a real overvaluation under such a regime is lethal for any country. Now, at the

close of the 1990s, what has captured the imagination of many is the idea of superfixed exchange rates, either of the currency board type or full dollarization.

More specifically, the idea is for a currency board or dollarization.

It is worth remembering that few people back in 1995 gave the Argentine currency board a fighting chance. Yet today it is the hero du jour, as Argentina has shown itself able to withstand in sturdy fashion the recent sharp vagaries of international financial markets. We have thus come more than full circle: having gone from the crawling peg to fixed rates and a fascination with credibility, we have passed through various infatuations with less rigid arrangements, only to return with a passion for the even greater fixity that a currency board or dollarization represents.

How can countries realistically achieve currency stability?

Yet it would be a mistake to suggest that at any time in this long odyssey did we abandon the notion that exchange rates should be stable. Indeed it trivializes the discussion to argue that exchange rate stability is better than exchange rate instability. That is a straw man argument-no one wants exchange rates to be unstable. The question is rather how best to adopt a stable exchange rate regime and how to avoid wishful thinking in doing so. It is unrealistic, for example, to advocate both currency stability and 9 percent annual growth. Why stop there? Why not ask for 15 percent growth, and zero inflation and zero unemployment to boot? Instead we should ask how countries can realistically achieve currency stability, and how they can move from one regime to another with the least disruption.

Argentina's currency board, although successful, does not itself provide enough support for dollarization.

Much of the current discussion of dollarization and the benefits it offers for Latin America also trivializes what is really a very complex situation. The enthusiasm for dollarization seems to me based on what I call one-observation economics: it depends too heavily on the experience of just one country, Argentina. Now, I have been on record for quite some time as expressing tremendous admiration for what Argentina has accomplished. Indeed, I would argue that Argentina today has the best economic team of any in the region. But my econometrics instructor taught me many years ago that the number of degrees of freedom in any sample is n - 1, or one less than the number of observations. That means that if you have only one observation, you have no degrees of freedom. Thus, to generalize from one country's experience and advocate, as some in the media have done, that Latin America move quickly to adopt dollarization is to read more into the data than the data will support.

One regime type does not fit all countries.

It is clear that, in the area of exchange rate policy, one size does not fit all. Certain types of regime are appropriate for certain countries, and other regimes for others. Although I am convinced that a currency board, and maybe even dollarization, is the right system for Argentina, I am equally convinced that it would be the utmost frivolity to think that, say, Ecuador, could go in that direction.

Bilateral dollarization is unrealistic.

What, then, are the prospects for dollarization in the rest of Latin America? First, one must specify what kind of dollarization one is talking about, because it comes in several flavors. One is bilateral dollarization, in which one enters into a treaty with the United States to use its currency. I am certain that the chances of this kind of dollarization being implemented in the short to medium run are precisely zero. It is hard to imagine that the United States would willingly absorb the costs. One can easily imagine the congressman from Des Moines or Denver berating from his committee seat the poor Treasury officials who dared suggest such a thing: "Why should we pay the Argentines for them to use our currency? If their currency is no good and they want to use ours, they should be paying us!"

As for unilateral dollarization, only Argentina is prepared.

As for unilateral dollarization, perhaps one or two countries in the region could pull it off. One is Argentina, and indeed it makes eminent sense for Argentina to do so. The studies published by Argentina's central bank show clearly that Argentina is ready to make the relatively small step from a currency board to dollarization. But few if any other countries are in that position. Maybe El Salvador-but then again probably not even El Salvador.

Gradual dollarization may be attainable now for some countries and perhaps, in the future, for all countries.

If the answer to the question of immediate dollarization is for most countries a clear no, the answer to the question of gradual dollarization is maybe. Maybe for some countries beginning today, and maybe for the region as a whole in the far distant future when we have achieved much deeper economic integration. Such an approach would entail, as a first measure, adopting a currency board just as Argentina did. How many countries are ready for a currency board? I think not many. The requirements for a currency board are well known, and it is equally well known that some of the countries now being suggested as candidates do not come close to meeting them. We learned in the previous session that Venezuela, for example, has a fiscal deficit equivalent to 8 percent of GDP. A currency board will not work under such conditions.

Most countries have little alternative but to float.

If dollarization and currency boards are nonstarters for most countries in the region, what other options are there? All the intermediate options between fixed and floating rates-adjustable rates, managed floats, crawling pegs, crawling bands, to name a few-are losing popularity. So we are left with the two extremes, and as I have argued, one of these works wonderfully in Argentina but probably nowhere else, for now at least. And this means in practice that most countries have little alternative but to float.

The Mexican experience typifies a successful float.

Before this conclusion is dismissed as a counsel of despair, we would do well to look at the recent Mexican experience, which has not yet received the attention it deserves. From the beginning of 1996 until October 1997, when Hong Kong's currency board came under attack, the Mexican peso was remarkably stable. Even if one considers the whole of the period from early 1996 to the present, the peso has not been more volatile than some of the major currencies that have floated for years. In fact, a study we did at the University of California, Los Angeles, suggests that the peso-dollar rate has been less volatile than the yen-dollar rate or the dollar-deutsche mark rate, and about as volatile as--but not more than--the exchange rate between the U.S. and the Canadian dollar. Other conventional objections to floating are that markets are not deep enough, that hedging is impossible, and that people in developing countries are not used to dealing with a floating currency or not smart enough to do so. I think Mexico has shown that none of these arguments are convincing. And I agree fully with José Gurria that if Mexico had had a fixed exchange rate or a currency board during the recent turbulence, the costs in terms of unemployment and recession would have been much greater than what Mexico actually suffered.

Although Argentina's currency board worked well, they sustained heavy costs in the adjustment to it.

Although, again, Argentina's currency board has worked well, people often overlook the heavy adjustment costs that Argentina has had to pay to maintain it. The Wall Street Journal recently published on its editorial page an article touting fixed rates, whose main point was that Argentina had done marvelously and Mexico rather poorly. But this is just more one-observation economics. The article argued that, following the tequila crisis, GDP fell by 6 percent in Mexico but only 4.4 percent in Argentina. So Argentina wins. What the article failed to mention was that Mexico had been obliged to erase a current account deficit of

8 percent of GDP, whereas Argentina's current account adjustment was only 3 percent of GDP (from 5 percent to 2 percent). What the comparison really shows, then, is that Mexico's exchange rate regime successfully turned around a much larger deficit than Argentina, at only a slightly higher cost to output. The fact that Mexico suffered a modestly deeper recession is not grounds for condemning floating rates.

More countries in the region should adopt floating regimes.

I would therefore propose that more countries in the region adopt floating exchange rates. Chile is one good candidate, and maybe Colombia and Venezuela as well. The key, however, is not to make the switch under duress but to do it when the economy is relatively strong. Under those circumstances the floating rate regime should perform relatively well and help generate the stability we all seek.

The prospects for Brazil are encouraging.

Turning to Brazil, we would all like to know what the immediate future holds for that country. And I think the new Brazilian program has better than a fighting chance. The accession of Arminio Fraga to the governorship of the central bank lends the program enormous credibility, and the announcements that have been made since he took over should give the markets great comfort. Brazil is right to maintain a floating exchange rate not only for the time being but for a long time to come. Inflation targeting is exactly the way to go, and I agree with the general view that the level of interest rates will be key to the outcome.

As the crisis in Brazil was one of bank-lending, recovery rests in the roll over of credit lines.

But when we look closely at the Brazilian crisis, we see that it does not look at all like the Mexican crisis of 1994-95 or many of the other recent crises. With the Brazilian crisis we are, so to speak, back to the 1980s. The crisis is not in the bond markets; rather it is a crisis of bank lending. If Brazil is able to convince the bankers of the world--and it should be able to, with Arminio at the helm--that the program has better than a fighting chance to succeed, the banks will begin to roll over the lines of credit that they have cut. And that, in my view, is the weakest link in the whole system. Arminio has extensive experience in restructuring bank debt, and he will surely be of great help in these negotiations.

Finally, capital controls are ineffectual and should not be imposed.

Finally, a word or two about the international financial architecture, or one aspect of it. I agree with Secretary Gurria that it would be a terrible mistake, once the current difficult times have passed--and they will pass--to impose controls on short-term capital. The Chilean controls have won much praise, but the more I look at the Chilean experience and subject it to various statistical and technical tests, the less impressed I am. Chile's controls have been both ineffective and costly; they are smoke and mirrors; they do not work. Today controls on inflows are not an issue, because not much capital is entering Latin America in any case, but when the boom times return and capital is again flowing in, countries should think very carefully before applying controls. My Chilean friends reply that they have not abolished capital controls--they have simply set the reserve requirement at zero percent. They are reserving, or so they proudly claim, the right to restore the requirement to 20 or 30 percent at any time. But I believe the time for that kind of policy is over for most countries in the region. They may still have a role in Ecuador--maybe. But for Argentina and the rest of Latin America, capital controls would be a huge mistake.