

Currency Regimes: The Latin American Experience

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The correct choice of monetary and exchange rate regime is vital to the development of an economy. It is unfortunately a difficult balance to achieve. Chris Dailey focuses on the Latin American experience before broadening his argument to a more global perspective.

Introduction

The global financial turmoil experienced in recent years has rekindled the debate on the appropriate choice of monetary and exchange rate regime. Over the last few decades an array of exchange and monetary arrangements have been employed with the aim of fostering economic stability and sustained growth. In emerging market regions such as Latin America, this choice has proven vital to the level of macroeconomic performance. The exchange rate regime is often blamed for economic ills and praised for good fortunes. Latin American countries have tried nearly every possible exchange rate permutation without a single and unparalleled route to success emerging.

Following the recent bout of currency crises and failure of the *'limited flexibility'* regimes, we are seeing a shift towards the extreme positions. Today, the exchange rate debate centres on the following question: should emerging market countries allow their currencies to float freely, should they bolt them down with super-fixed exchange rates such as currency boards or should they abandon them altogether in favor of a strong international or supranational currency? This essay will analyse the experience of Latin American countries regarding exchange rate and monetary policies. It will ask specifically which of these arrangements has the best record in economic performance. The paper will then conclude with a brief discussion of the viability of dollarization as an alternative to domestic currency regimes in the developing world.

The Current Policy Environment

There are several ways of delimiting the expansive continuum of exchange rate arrangements. Cato Institute economist Steve Hanke classifies exchange rate regimes into three broad categories: freely floating, fixed and pegged¹. With a

¹ Hanke (1999)

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floating rate, a monetary authority sets monetary policy, but has no exchange rate policy since the currency is allowed to move freely with the fluctuations of the market. A fixed rate, on the other hand, entails the monetary authority holding the exchange rate fixed while relinquishing all control over monetary policy. Pegged rates, such as those employed in South East Asia, Russia and Brazil, prior to the recent crises, require a monetary authority to manage both exchange rates and monetary policy. Such *intermediate* arrangements include crawling pegs, crawling bands and target zones that have been used throughout Latin America to gain a greater degree of flexibility in monetary policy while maintaining an exchange rate target. Unlike pure floating or fixed rates, however, pegged rates invariably lead to conflicts between monetary and exchange rate policies. This situation is exacerbated as capital mobility increases; balance-of-payments crises can ensue and these regimes become more vulnerable to speculative attack². This is a central reason for the shift towards the extremes as mentioned above.

The IMF currently classifies exchange rate regimes into eight categories. *Table 1* and *Table 2* reflect the strong shift in recent years away from the middle of the spectrum and towards more flexible arrangements. Argentina is the only Latin American country to completely give up its monetary policy by adopting a currency board in 1991.

Table 1: Exchange Rate Arrangements in Latin America (as of April 4, 1999)

| | |
|--|---|
| Independently Floating (4) | Peru, Mexico, Brazil, Ecuador, Guatemala |
| Managed Floating with a Pre-announced Path (1) | Paraguay |
| Exchange rates within crawling bands (5) | Colombia, Chile, Honduras, Uruguay, Venezuela |
| Crawling pegs (3) | Bolivia, Costa Rica, Nicaragua |
| Pegged exchange rates with horizontal bands | |
| Conventional fixed peg arrangements (1) | El Salvador |
| Currency Board Arrangements (1) | Argentina |
| Currency Union or Foreign Currency as Legal Tender (1) | Panama |

Source: IMF, International Financial Statistics, October 1999.

² This occurred for example in Mexico (1995), Thailand (1997), Russia (1998) and Brazil (1999).

Table 2: Fixed Exchange rate countries in Latin America, 1979-1999

| 1979 | 1982 | 1985 | 1991 | 1999 |
|-------------|-------------|-----------|-----------|-------------|
| Bolivia | Ecuador | Guatemala | Argentina | Argentina |
| Chile | El Salvador | Honduras | Nicaragua | El Salvador |
| Costa Rica | Guatemala | Nicaragua | Panama | Panama |
| Ecuador | Honduras | Panama | | |
| El Salvador | Mexico | Paraguay | | |
| Guatemala | Nicaragua | Peru | | |
| Honduras | Panama | Venezuela | | |
| Nicaragua | Paraguay | | | |
| Panama | Venezuela | | | |
| Paraguay | | | | |
| Venezuela | | | | |

Source: Edwards (1995)³ and International Financial Statistics (1999).

What can explain this shift? In a world of increasingly mobile capital, countries can no longer fix their exchange rate and at the same time maintain an independent monetary policy. This is called the *Impossible Trinity*⁴, whereby international capital mobility, fixed exchange rates and domestic monetary independence are mutually incompatible⁵. In other words, if the government wants to control both the exchange rate and the interest rate, then it must impose effective capital controls⁶. Looking at today's environment of increasing financial integration and high capital mobility, however, the choice is largely left down to giving up either exchange rate stability or monetary independence. Thus far, most have chosen to maintain monetary independence.

The Latin American Experience

Does this necessarily mean that flexible exchange rates and monetary independence are better for Latin America? The choice essentially lies between the confidence and stability offered by a fixed rate and the control over policy allowed with floating rates.⁷ In theory the choice between floating and fixed exchange rates lies in a

³ Edwards (1995)

⁴ Frankel (1999)

⁵ Hermalin & Rose (1997)

⁶ Hausmann (1999b)

⁷ Economist (30/1/99)

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country's vulnerability to external shocks. A floating currency allows adjustment to external shocks through the exchange rate, whereas under a fixed rate, such a shock will put pressure on domestic prices and wages instead. Thus under flexibility, interest rate policy can be used to achieve internal balance while the exchange rate is allowed to move to achieve external balance. This is not possible with fixed rates since the authorities have no power over monetary policy.

Many of the regime changes in recent years were adopted in the hope that the theoretical benefits of floating would come to fruition. Unfortunately, the proven track records of these regimes have not always mirrored the theoretical benefits they promise. In fact, rather than stimulating competitiveness and allowing lower interest rates, devaluations in Latin America have proven contractionary⁸. In a recent study by the Inter-American Development Bank, Hausmann *et al*⁹ find that flexible arrangements have not permitted a more stabilising monetary policy in Latin America, but instead have tended to be pro-cyclical. This has resulted in higher real interest rates, smaller financial systems and greater sensitivity of domestic interest rates to movements in international rates. Latin America simply does not have the ability to use exchange rate flexibility effectively as theory predicts it should.

There are a variety of explanations for these findings. One is that emerging markets simply do not possess the investor confidence and credibility that the industrialised economies have. This is largely the reason why devaluations enabled countries in Europe to effectively adjust following the ERM crisis in 1992, yet caused severe difficulties for Mexico and others in 1994. Furthermore, as Hausmann¹⁰ points out, flexible regimes are sometimes managed as if they were fixed but without the benefits of the pre-commitment provided by fixity. This was illustrated in Chile, Mexico, Peru and Venezuela during 1997-1998 as these countries reacted to economic difficulties by dramatically increasing interest rates rather than letting the currency move¹¹. Hence, when the market observes adverse economic shocks and no depreciation, it anticipates that at any moment the authorities might change course and let it take place. Such uncertainty implies a higher currency premium and results in real interest rates remaining high, especially in difficult times.

There are several reasons why authorities in developing countries are wary to allow the free movement of exchange rates. Flexible regimes face heavy costs when

⁸ Calvo (1999)

⁹ Hausman (1999a)

¹⁰ *ibid*

¹¹ Hausmann (1999b)

depreciations occur. De facto wage indexation is more likely under these regimes. This is because workers want to protect their wage agreements from unexpected changes in prices. Such anticipation in turn reduces the ability of exchange rate flexibility to affect competitiveness. Furthermore, many assets and liabilities in Latin America are already dollar denominated, leading to potential defaults following large depreciations. It is not surprising then that countries such as Costa Rica, Ecuador, Peru, Uruguay and Venezuela have used depreciations only as a means of keeping up with inflation differentials.¹².

A Strong Fix May Be Better

While the benefits of the '*intermediate fixes*' have proven limited, strong fixes such as currency boards have been successful when they are credible. The generally cited benefits of fixed rates are the reduction of exchange rate risk that discourages trade and investment and the provision of a credible nominal anchor for monetary policy. The argument for currency boards is essentially an extension of the argument for fixed exchange rates. A strong exchange rate anchor constrains the scope for excessive monetary expansion, helping to solve the time-consistency problem and acting as a deterrent to self-fulfilling runs. This engenders discipline and thus confidence in the domestic currency. In turn this results in better inflation performance, lower real interest rates and faster growth¹³.

Institutional and legal arrangements such as that in Argentina generally make a currency board much harder to compromise than a typical fixed rate. In an IMF study, Ghosh *et al*¹⁴ find that inflation under currency boards was about four percentage points lower than under other fixed/pegged regimes. They attribute this to the monetary discipline such arrangements impose, but claim the far more important factor is the increased confidence in the currency. This confirms the observation that the success of emerging market economies often boils down to an issue of credibility.

Looking at the data compiled in *Table 3*, it is evident that deposit and lending rates are lowest in the countries with highly fixed arrangements, as are inflation rates. The performance of Argentina is only surpassed by Panama, which has officially adopted the US dollar. These numbers confirm the findings described above, showing the

¹² Hausmann (1999a)

¹³ Ghosh *et al* (1998)

¹⁴ *ibid*

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price of floating to be quite significant in terms of interest rate differentials and inflation levels.

Table 3: Average Deposit Rates, Lending Rates and Inflation Rates, 1996-1999

| Country | Current Exchange Rate Regime | Deposit Rate (%) | Lending Rate (%) | Inflation Rate (%) |
|-------------|------------------------------|------------------|------------------|--------------------|
| Brazil | Independently Floating | 26.70 | N/A | 7.72 |
| Ecuador | Independently Floating | 38.46 | 51.25 | 34.48 |
| Guatemala | Independently Floating | 6.53 | 19.27 | 8.22 |
| Mexico | Independently Floating | 16.20 | 29.53 | 22.71 |
| Peru | Independently Floating | 15.46 | 29.56 | 7.98 |
| | Average | 20.67 | 32.40 | 16.22 |
| Paraguay | Managed Floating | 15.58 | 29.11 | 9.29 |
| | Average | 15.58 | 29.11 | 9.29 |
| Chile | Crawling Band | 12.47 | 16.72 | 5.70 |
| Colombia | Crawling Band | 27.96 | 37.93 | 18.24 |
| Honduras | Crawling Band | 19.14 | 30.80 | 17.85 |
| | Average | 19.86 | 28.48 | 13.93 |
| Bolivia | Crawling Peg | 14.92 | 45.95 | 7.04 |
| Nicaragua | Crawling Peg | 11.62 | 21.31 | 11.36 |
| | Average | 13.27 | 33.63 | 9.20 |
| El Salvador | Conventional Fixed Peg | 11.79 | 16.33 | 4.65 |
| | Average | 11.79 | 16.33 | 4.65 |
| Argentina | Currency Board | 7.34 | 10.18 | 0.24 |
| | Average | 7.34 | 10.18 | 0.24 |
| Panama | Dollarized | 7.00 | 10.60 | 1.10 |
| | Average | 7.00 | 10.60 | 1.10 |

Source: IMF, International Financial Statistics.

Interest rates are also less sensitive to world interest rates in countries with no exchange rate flexibility. Research by Jeffrey Frankel¹⁵ finds that the exchange rate uncertainty created under floating regimes exacerbates swings in the country risk premium. When the US interest rate increases, Frankel finds that rates in Panama are

¹⁵ Frankel (1999)

least sensitive, followed by Argentina's rates, while rates in Brazil and Mexico (countries that float against the dollar) are much more sensitive.

The Drawbacks of Fixed Rates

All this said, fixing the exchange rate through a currency board arrangement is by no means a panacea. The extra credibility engendered by a currency board comes at a price. Currency boards are far more constraining on credit policy and can create severe adjustment problems when faced with external shocks. This is evidenced by Argentina's difficulty in pulling out of the recession caused by Brazil's currency collapse in January 1999. Furthermore, a currency board is not viable for all countries. It is only likely to be successful when solid fundamentals exist. These include adequate reserves to fully back the monetary base, fiscal discipline, a strong well-supervised financial system and respect for the rule of law.¹⁶ It is also worth noting that while currency boards protect from speculation against the currency, they do not necessarily protect a country from speculation against the economy. If the currency board were to fail under such speculation, the consequences would be catastrophic.¹⁷

Conclusion

The above analysis has argued that exchange rate flexibility, on average, has not been an asset for Latin American countries. It has not allowed more independence in monetary policy, it has led to higher interest rates, higher interest rate volatility and has encouraged de facto wage indexation. This, along with heavy liability dollarization, has contributed to the revealed preference of policy-makers away from using their flexibility.

It is apparent from the data in Latin America that strong exchange rate anchors such as currency boards have performed better than their more flexible counterparts. If the currency is to remain fixed and monetary policy constrained, however, then what is the benefit of maintaining a national currency at all? There certainly remains a degree of currency risk that could be eliminated by adopting the US dollar as legal tender. Dollarization is the most serious form of commitment to maintaining the value of a currency and would likely lower interest rate differentials even further.

¹⁶ Frankel (1999)

¹⁷ Krugman (1999)

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This possibility is confirmed by IMF¹⁸ research showing that the average stripped spread on Argentine sovereign bonds between September 1, 1994 and April 12, 1999 was 736 basis points, while in Panama (the only dollarized Latin American country) this averaged 405 basis points. This provides a good indicator of the potential reduction in country risk premia that could be possible if countries such as Argentina were to dollarize. The global economy may have much to gain with the elimination of unstable currencies such as those in Latin America. As the chief economist of the Inter-American Development Bank so succinctly puts it, "...the world is moving toward a situation where there are two soft drink corporations, two airplane manufacturers, three toothpaste producers and 180 central banks printing their own currency."¹⁹ Considering today's rapid financial integration, and the increasing attractiveness of dollarization or supranational currencies such as the euro, it is not difficult to picture a global economy consisting of only two or three major currencies within the next several decades.

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