Jean-Pierre Allegret: Exchange Rate Regimes for Emerging Countries. Perspectives for the 21st Century (Vuibert Editions, 2005)

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The multitude of exchange rate crises during the 1990s has led many international organisations to consider the choice of the exchange rate regime in emerging economies as a crucial aspect of the new international financial architecture.

Indeed, most academic economists and practitioners are interested in determining which type of exchange rate regime would be appropriate for the emerging markets' internal stability and their long-term participation in the international financial system.

The choice of the exchange rate regime has been widely discussed since the end of the 1960s, when the monetary crises of the Bretton Woods system divided economists into two fields: the supporters of floating exchange rate regimes and those supporting fixed agreements.

Arguments in favour of floating exchange rates, such as the independence of national monetary and exchange rate policies, have been opposed to those in favour of fixed regimes, which highlight the adverse effects of capital volatility and lack of stability, and vice versa. Moreover, since the 1980s, international financial integration has put into light the argument of the *Inconsistent Trinity,* pointing out that a country cannot have simultaneously a fully liberalized capital account, pegged exchange rates and monetary policy autonomy. So, if the capital account becomes fairly open, the national authorities must decide between letting go the autonomy of their monetary policy or the fixity of their exchange rate.

The choice of a "good" exchange rate regime for an economy is very difficult. Indeed, it seems that there is not an "optimal" exchange rate regime and the national authorities are forced to make a choice between stability and flexibility.

This problem is much more complex for emerging economies. This group of countries is very heterogeneous and includes such countries as China, Taiwan, Brazil and the Central and Eastern European countries. Their identification is based on several criteria such as financial (stock market capitalisation)

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and real variables (GDP per capita). But all these countries have had a rapid growth during the 1980s, which was due to several factors:

i) important structural reforms and economic market liberalisation,
ii) important progress in political stability and democratization,
iii) financial innovations and modernization of capital markets,
iv) economic stabilisation characterized by lower inflation and lower fiscal deficit.

These factors have made emerging economies particularly attractive for foreign investors and increased their weight in the global economy (in terms of global GDP, their part has increased from 14,1% in 1992 to 23,3% in 2003).

In this context, economic stability in emerging markets has become an important issue for developed economies.

Several important vulnerabilities of emerging markets can be identified:

i) volatility of capital flows guided by international interest rate variability and foreign investors' opinions;
ii) sensitivity to the developed countries' economic growth;
iii) and to their exchange rate movements. Here, three transmission canals can be distinguished (commercial, FDI, and currency crises).

Considering all these particular factors and interactions between emerging and developed economies, the choice of the exchange rate regime for emerging markets remains a very complex and laborious task.

"Exchange rate regimes for emerging countries. Perspectives for the 21st century" is an invaluable guide for economics students and financial sector practitioners trying to understand the main problems touching the international financial system.

This book provides some important answers to the questions concerning the choice of the exchange rate regime in emerging economies. The choice of the exchange rate regime is considered here from a double perspective: recent theoretical viewpoints on the subject are enlarged by empirical studies exposing the pros and cons of each regime.

This synthetic study presents an overview of the most recent works on the subject without the elaborate technical and econometric details, but using a more analytical approach of tables and figures, and economic mechanisms between different variables. In so doing, **Jean-Pierre Allegret** presents the essential elements for understanding the current debate that claims that emerging countries need to polarize to one of the extreme regimes: *a free float or a hard fix*. But, he underlines that the emerging economies involved in the international capital markets are vulnerable and, from an internal stability point of view, it could be difficult to adopt and maintain the corner solutions in these countries.

His analysis is organised as follows.

Chapter 1 studies the determinants of–exchange rate regime choice, showing the principal evolutions of exchange rate regimes in emerging economies and the relations between exchange rate regimes and macroeconomic performance of these countries. This part introduces the definition and classification of exchange rate regimes based on the *de jure* and *de facto* distinction.

Chapter 2 discusses the vulnerability of intermediate regimes from a theoretical point of view. Indeed, the aftermath of the global financial crises in the 1990s has led to the current prevailing attitude that claims that all intermediate exchange rate regimes are vulnerable to speculative crises and increase economic instability.

In this chapter, three approaches are considered:

i) the model of currency crises initiated by Krugman in 1979 (the 1st generation models)
ii) the multiple equilibria models developed by Obstfeld in 1986 (the 2nd generation models)
iii) some empirical studies relative to currency crises highlighting the main component of the 1990s crises : *self – fulfilling phenomena*.

Chapter 3 analyses the influence of financial vulnerability on the exchange rate regime. Indeed, the 1990s crises highlight the important role of financial factors in the occurrence and consequences of these crises. The main objective of this chapter is to propose theoretical foundations (the 3rd generation models) to *the twin crises* phenomenon and to present their empirical characteristics.

Chapter 4 studies the characteristics of hard peg regimes. These regimes establish a strict and strong relation between domestic and foreign currencies. In so doing, the national authorities increase the credibility of the chosen regime and decrease domestic interest rates, which boosts economic growth. Provided the rate is fixed and credible there is no point in speculating, which decreases the probability of speculative attacks. In this chapter, benefits and costs of currency boards and dollarization are also presented.

The last chapter, Chapter 5, discusses two aspects of floating: adjustment to economic turbulence and monetary policy independence.

At the beginning of the 1950s, Friedman underlined the advantages of floating regimes, such as the flexibility and autonomy of monetary policy. At the beginning of 1960s, Mundell put forward the efficiency of floating regimes in the face of real external shocks (which is particularly true in the case of emerging markets) in restoring equilibrium. However, during the 1990s, many economists have questioned the flexibility of exchange rate regimes, putting forward the phenomenon called *fear of floating* (Calvo and Reinhart, 2002). In this context, the main objective of Chapter 5 is to study the usefulness of floating regimes for emerging countries, considering the necessity of alternative monetary pegs such as direct inflation targeting. But, although there are many advantages to adopting this corner solution accompanied by DIT in emerging countries, their characteristics make a free float impossible to maintain and therefore, some degree of fixity must also be introduced in the form of *intermediate regimes*.

The main conclusion of this book is that the stability of emerging countries depends mostly on the new architecture of the international monetary and financial system. Indeed, the new system should include a double regime under ~~the~~ IMF control: a **target zone "dollar - euro – yen"**, with the aim of limiting disorderly fluctuations of exchange rates, and **a particular choice of exchange rate regime for emerging markets,** which, in the context of international financial liberalization, should be based on two pillars:

i) Direct inflation targeting with intermediate exchange rate regimes. Large bands should be adopted with the aim of limiting the variability of exchange rates and the conflict between DIT and exchange rate objectives.

ii) Restoration of capital controls. This measure, established under IMF authority, could limit the destabilising effects of international financial liberalisation.