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Book Review

[Book Review of] Exchange rate policies in developing and post-socialist countries : an International Center for Economic Growth publication, Claassen, Emil-Maria (ed.), San Francisco, ICS Press, 1991

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quick introductory guide to the facts of Latin American economic development, and to the corresponding policy debates. Although the text is apparently aimed primarily at a North American audience, students in Latin America and elsewhere will derive equal benefit from it.

Matthias Lücke

Claassen, Emil-Maria (Ed.), Exchange Rate Policies in Developing and Post-Socialist Countries. An International Center for Economic Growth Publication. San Francisco 1991. ICS Press. XIX, 443 pp.

The exchange rate regime is at the center of discussions about appropriate reform strategies for post-socialist countries as it has always been the case for traditional developing countries. In the light of the controversy about the comparability of the two country groups, it is to be appreciated that the thirteen papers included in the conference volume discuss the question of the optimal exchange rate regime for both post-socialist and traditional developing countries. The book contains a discussion of most of the relevant determinants of an optimal exchange rate regime. The technical analysis in the text is limited to graphical presentations (with only a few exceptions). The book is therefore recommendable for economists and policy-makers looking for an introduction into the topic. But especially for this type of reader it is always difficult to find the main lines of reasoning. The introduction given by *Claassen* (Ch. 1) is helpful because it gives a good summary of all arguments but it fails to make up a story and to address the most interesting question: are there different conclusions for post-socialist and traditional developing countries?

In order to answer this questions, I would recommend to start reading with the contributions of *Mundell* (Ch. 2) and *Williamson* (Ch. 14) because they can be interpreted as a general view, i.e. the arguments provided are valid for all country groups. Mundell demonstrates in a general equilibrium setting that an adjustment to real shocks or the stabilization of the price level is possible with fixed exchange rates as well as with flexible exchange rates and a money supply target. Mundell's conclusion that in order to generate confidence in money "...(t)he money supply will not suffice as an anchor..." and "...(t)he best means of establishing this anchor is to make the currency convertible" (pp. 40 f.) is only based on his observation that "...flexible exchange rates have not been successful in developimg countries" (p. 40). Mundell proposes a narrow concept of convertibility, i.e. convertibility of domestic money at a fixed price into a stable currency (currency convertibility) and into gold (asset convertibility). The implication is that monetary policy is completely passive and dependent on (gold) reserve flows and the Central Bank acts as a currency board.

Mundell's conclusion is at least based on a benign neglect of bad experiences with fixed exchange rates in developing countries. It is sufficient to mention the bad experience of the Southern Cone countries at the beginning of the 1980s. Williamson raises additional doubts from a general perspective whether a fixed exchange rate is an optimal exchange rate regime. First, "(w)here the inflation rate has too much momentum to be stopped by an exchange rate commitment..., I recommend a real target..." (p. 401), i.e. a real exchange rate target. Otherwise inflation is reduced at the cost of external disequilibrium. Second, "(e)ven if the target is initially set correctly, it will need to change if a permanent real shock creates a need for payments adjustment" (p. 401). The implicit assumption made by Williamson is that the prices of non-traded goods are not as flexible as (implicitly) assumed in Mundell's general equilibrium setting. Williamson goes a step further in arguing that the equilibrium real exchange rate has to be estimated. This is of course nearly impossible even for developed countries with relatively stable economies. Additionally, it is not necessary to calculate a target. A

backward-oriented passive crawling peg (adjustment of the nominal exchange rate for past inflation differentials) with a band allows for changes of the real exchange rate by market forces, i.e. either by exchange rate changes (within the band) or by monetary policy (outside the band for the nominal exchange rate). The target is always the actual real exchange rate [Schweickert, 1993 a].

The central contribution with respect to the situation of developing countries is provided by *Aghevli* and *Montiel* (Ch. 8). This chapter contains an empirical part sufficient to inform the reader about all relevant developments in the recent past and to demonstrate the tendency to allow for greater flexibility of exchange rates. The analytical part gives a very good, non-technical summary of four issues related to the choice of an exchange rate regime which have been discussed recently: time inconsistency of policy announcements, real overvaluation, balance-of-payments crisis and the interdependence of fiscal and monetary policy. The time-inconsistency literature shows that the authorities have an incentive to renege on former commitments. If monetary policy is made completely passive – as proposed by Mundell – monetary authorities would loose the possibility to do so. An institutionalized fixed exchange rate would thus raise the credibility of a reform program. But there may be socially desirable exchange rate changes. Real exchange rates in developing countries tend to be overvalued. Aghevli and Montiel show that there may be contractionary effects if the nominal exchange rate is devalued in order to achieve real exchange rate adjustment but they conclude that these can only be short-run effects and the alternative would be to reduce the real exchange rate by keeping the domestic inflation rate below those of the major trading partners. But there are not only doubts whether a fixed exchange rate is desirable – it may also be not sustainable. The monetary contraction necessary to reduce domestic inflation below foreign inflation comes automatically in a fixed exchange rate regime and a passive monetary policy via reserve outflows. These reserve outflows may reduce the stock of reserves dramatically, leading to a balance-of-payments crisis, i.e. a run on the remaining reserves. The monetary contraction also implies a fiscal discipline which may not be sustainable in countries with underdeveloped tax systems. "Tying one's hands" therefore does not necessarily raise credibility.

The relationship between monetary and fiscal policy is a very important one. Both fixed exchange rate regimes and flexible exchange rates with money supply rules need the independence of monetary policy from fiscal policy. The monetary discipline required for achieving a given inflation target is the same in both regimes. It has to be possible given the fiscal constraint. The contributions of *Fernandez* (Ch. 11) and *Pinto* (Ch. 12) demonstrate that this is not given if a large share of the public budget is financed by the inflation tax. Fernandez describes the futile attempts by Argentine authorities to circumvent monetary discipline by price controls and to avoid fiscal adjustment by borrowing on a thin domestic capital market and creating a huge quasi-fiscal deficit of the central bank. Authorities lost their remaining credibility and a run of foreign exchange led to hyperinflation. Pinto analyses the trade-off between raising an inflation tax and raising a premium on the foreign exchange market by an overvalued official exchange rate. If the premium is reduced by exchange rate adjustment and the government suffers a loss in revenue, it will have to increase revenue from the inflation tax or to implement a fiscal reform. The conclusion for the currency regime – not drawn by Fernandez and Pinto – is that without a fiscal reform which makes the government budget independent from collecting an inflation tax or levying a premium on foreign exchange the implementation of anchors for the monetary policy is impossible.

So far, it has been assumed that allowing the real exchange rate to adjust to its equilibrium level and reducing inflation should determine monetary and exchange rate policy in developing countries. Actually, *Lal* (Ch. 10) is able to identify real exchange

rate misalignment and acute inflation as the main causes for growth collapses in developing countries. He also demonstrates that there is no clear correlation between a type of shock and changes in the equilibrium real exchange rate. Effects of terms-of-trade shocks, e.g., depend on the labour intensity of the production of non-traded goods. That changes in the equilibrium real exchange rate depend on the structure of the economy is also demonstrated by *Edwards* (Ch. 9). Effects of current and capital account liberalization depend on the relative strength of income and substitution effects. In the most likely cases "... a capital account liberalization will require an equilibrium real exchange rate appreciation in the present period, a trade reform will call for a real exchange rate depreciation" (p. 251). In his conclusion that "... since capital liberalization tends to frustrate the depreciation required to sustain trade reform, the capital account should be opened up after the current account has been fully liberalized" (p. 251), Edwards is only concerned with the sequencing of liberalization. The relevant conclusion with respect to exchange rate policy is only implicit in his part dealing with the role of monetary factors. If there are changes in the equilibrium real exchange rate due to liberalization efforts, these have to be seen as real shocks like e.g. terms-of-trade shocks. The exchange rate system should be able to adjust the actual real exchange rate to the changing real exchange rate equilibrium in order to preserve internal and external equilibrium. Lal's and Edward's contributions show that real exchange rate equilibrium at a low level of inflation should be the aim of monetary and exchange rate policy. They also show that it is difficult in a developing country context to target the real exchange rate because the impact of internal and external shocks are difficult to predict.

If the main disequilibria have been removed, the clearcut aim of reducing inflation and overvaluation is substituted by stabilizing the real exchange rate at its equilibrium level. The main problem for the more advanced developing countries like the East Asian NICs is to define the appropriate real exchange rate as a target for exchange rate policy. *Park* and *Park* (Ch. 13) show that the choice is basically between the yen and the dollar. But the need to choose a basket of these currencies stems from the attempt to preserve monetary stability and to manage the exchange rate at the same time. Park and Park reject the possibility to float – which would solve the problem – because of (*i*) improper macroeconomic policies pursued by major currency countries, (*ii*) expectation of excessive capital flows and (*iii*) "... if, ..., trade and financial liberalization are the priority reforms, then (the countries) should try to maintain a correctly aligned exchange rate, taking into consideration the possible effects of financial liberalization" (p. 376). The first and the second argument are rather arguments in favour of a free float in order to insulate the economy and to discourage capital flows by exchange rate changes. With respect to the third argument, it has been shown by Edwards that changes in the equilibrium real exchange rate are difficult to predict in a liberalization process. Additionally, the reputation of East Asian NICs for monetary and fiscal discipline should guarantee relatively stable and market-determined exchange rates.

Contrary to the East Asian NICs, the situation of post-socialist countries is even worse compared with a typical developing country. They are even further away from macroeconomic equilibrium and they lack market institutions. *Lavigne* (Ch. 7) concludes that "... a multilateral monetary arrangement providing for settlements in the domestic currencies, with a commitment to make these currencies gradually fully convertible (for residents and non-residents) within the area and outside the area..." (p. 200) should be implemented in order to promote intra-regional trade and to economize on international reserves. It is rather surprising that she arrived at this conclusion after reviewing negative experiences with such an arrangement. There are three basic arguments against a payments arrangement. First, international reserves are saved only to a limited extent. The bulk of possible savings could be realized by bilateral arrange-

ments between central banks. Second, trade is promoted by such a system only to the extent that there are implicit subsidies paid due to misaligned exchange rates and limited convertibility. Third, it is generally accepted that convertibility is badly needed in post-socialist countries in order to import the world market price structure. In such a situation, subsidies which reduce the incentives to adjust exchange rates and to make the currency convertible are counterproductive.

A currency reform is also discussed as an institutional precondition for the reform of the monetary system. *Claassen* (Ch. 5) reviews the three currency reforms in Germany: the introduction of the rentenmark in 1923, the introduction of the deutsche mark in 1948, and the monetary union in 1990. With respect to the latter, Claassen concludes that "... the fiscal burden for the Federal Republic is the maximum possible..." (p. 137) but that "... (n)ational solidarity will make it easier for Germany than for Europe to support the fiscal burden..." (p. 142). If fiscal transfers are less likely in a situation where the recipient maintains full fiscal sovereignty, it can be doubted whether a currency reform by introducing a stable European currency as a legal tender is a viable option for post-socialist countries. According to Claassen, these essential ingredients of a currency reform are the elimination of the monetary overhang and signalling the credibility of future monetary policy. In Germany, the monetary overhang was reduced by inflation in 1923 and by confiscation of liquid assets in 1948. Both currency reforms had in common that the future monetary policy was credible. In my view, this gives the two ingredients of a currency reform different weights. Germany's experience shows that the credibility of the future monetary policy matters more than the currency reform, i.e. the technique of reducing the monetary overhang.

The credibility of monetary policy in post-socialist countries needs other institutional reforms. A monetary and exchange rate system can only stabilize an economy if money supply affects prices and if money supply could be controlled – either automatically in a fixed exchange rate system with a passive monetary policy or by a money supply rule. If the excess supply of money should affect prices, prices have to be liberalized before. However, *Brenner* (Ch. 6) argues that the liberalization of prices should be postponed until after property rights have been defined, a bankruptcy law has been set up, hard budget constraints for publicly owned enterprises have been set up, and an efficient financial system works. Without these institutional preconditions, entrepreneurs would not set prices according to competitive pressures, relative prices would be distorted, and a supply response would not be observed. But it has been shown by history that the old system of controlled prices is also not able to increase production in an efficient way. Moreover, many goods are traded at their black market prices anyway. Price liberalization then means to legalize the allocation process. Inflationary pressures – except for the elimination of an initial monetary overhang – are not to be expected in the case of a tight monetary policy. The distortion of relative prices stresses the need to import the world market price structure. This implies a uniform import tariff, abolition of non-tariff barriers and external convertibility. Ample evidence from developing countries shows that external convertibility without monetary discipline fuels imports for consumption or for inefficient investment purposes. Thus, monetary control complementing price liberalization seems to be the central institutional requirement in the transformation of post-socialist countries into market economies.

McKinnon (Ch. 3) analyses in a straightforward way how to implement monetary control in an economy in which the capital stock of nearly all important enterprises is owned and controlled by the government. According to his proposal, the banking system should consist only of a central bank which takes deposits from publicly owned enterprises, privatized enterprises, and private households. Deposits from publicly owned enterprises are not convertible, i.e. their withdrawal has to be authorized. The central bank gives credit to publicly owned enterprises and to the government only.

Private enterprises have to finance capital accumulation out of their own resources. This should provide an incentive to reduce hoarding of real goods.

Mc Kinnon's financial system accepts the fact that monetary policy depends on fiscal policy in the case of post-socialist countries. If independence of monetary and fiscal policy cannot be achieved because a tax system takes time to be implemented and to work efficiently, it is a good idea to make the dependence of monetary policy on fiscal policy explicit. This is the main advantage of McKinnon's proposal. The main flaw of McKinnon's system is that it introduces financial repression. It is a curious fact that the same author demonstrated in a seminal contribution to economic theory the negative effects of financial repression on economic development. Therefore, the banking system proposed has to be seen as a starting point for financial reform which has to be complemented by a prudent banking regulation allowing for the operation of private banks. The most interesting question in the context of the book is of course, if there are conclusions for the exchange rate system. Rearranging the balance sheet of the central bank as proposed by McKinnon is clearly inconsistent with exchange rate management and especially with a fixed exchange rate regime because there is no reserve component of the money supply. But it is consistent with flexible exchange rates and a money supply target which takes into consideration the fiscal needs.

All in all, the conference volume shows that there are additional (institutional) reform requirements in the case of post-socialist countries but that the general conclusions from the literature dealing with appropriate monetary and exchange rate policy in a developing country context maintain their validity. This means that the strong arguments for exchange rate flexibility in developing countries [see Balassa, 1990; Corden, 1993] also apply to post-socialist countries [see Williamson, 1991; Schweickert, 1993 b]. If the experience of developing countries is not considered in the design of the monetary system, post-socialist countries run the risk to repeat mistakes and to find themselves in the position of developing countries in the 1970s, i.e. with a still high share of public enterprises, highly distorted markets and significant macroeconomic disequilibria.

One of the flaws of the conference volume is the lack of such conclusions. Moreover, the title of the book ("Exchange Rate Policy...) provokes the expectation that each chapter draws conclusions on exchange rate policy. This is not the case. My own conclusions implicit and explicit in this review should be seen as a hypothesis which could be substantiated by the contributions included in the volume. The importance of the issue makes it worth to check this hypothesis by reading the book.

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