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Received: 12 April 2010.

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Exchange Rate Regimes in Emerging and Transition Economies

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The Faculty of Economics Subotica, 2009.

The choice of a sustainable exchange rate regime in emerging and transition economies is an essential and complex question in the current context of globalization and international financial fluctuations. The book *Exchange Rate Regimes in Emerging and Transition Economies* proposes a comprehensive analysis of this question and highlights the economic implications of this choice for countries according to their vulnerability to external shocks. The analysis is particularly interesting because the positions of emerging and transition economies are studied separately whereas they are generally considered in the literature as a single category.

Moreover, the investigation proposed is complete; the question of the exchange rate regime choice is envisaged from a historical, theoretical and empirical point of view. The approach is both general, in the field of international macroeconomics, and detailed with the presentation of reference studies; many key contemporary and pioneering concepts are used to treat the overall question. The analysis is based on a well-documented literature and underlines the fact that today, while transition economies tend to prefer fixed exchange rate regimes, emerging ones are in an intermediate position.

The authors point to the fact that traditional macroeconomic criteria are not sufficient nowadays to ensure the sustainability of a fixed or quasi-fixed exchange rate regime in emerging and transition economies at a national and regional level. In addition to fundamental long-run economic stability, it is essential to consider the strength of the banking and financial sectors of the country and its dependence on developed economies' macroeconomic evolution. Moreover, political stability is one of the main criteria guaranteeing the credibility of the fixed exchange rate regimes in these countries. This helps to avoid speculative attacks and the spread of financial shocks between countries in periods of international crisis.

Moreover the authors underline the fact that in a transition economy, when the fixed exchange rate regime is not sufficiently sustainable, an exit strategy towards a more flexible exchange rate may be adopted. However, this decision must be taken at a suitable period in order to limit devaluation pressures on the exchange rate.

Though the book is moderately technical, the presentation of the theory of reference is very clear and detailed. It is in the main meant for readers who are specialists in macroeconomics and international finance because a good knowledge of the major concepts of the literature on exchange rate regimes is needed (postgraduate students, researchers, academics and professionals...). However, some parts of the

book are accessible to a wider audience (chapter I, for example). This approach proposes a high level overview of the problematic and consequently represents a good base for research studies concerning exchange rate regime choices in Southeast Asia, Latin America, East European and North African countries.

The book is divided into four different and complementary parts. The first three sections constitute a synthesis of the literature on exchange rate regimes, in particular in emerging and transition markets. The last section proposes an original empirical analysis focusing on monetary and exchange rate regime changes based on the cases of Poland, the Czech and Slovak Republics and the Republic of Serbia which have recently experienced a transition from a fixed to a flexible exchange rate regime.

The opening section presents the subject in a historical perspective by recalling the evolution of the international monetary system during the 20th century (Classical Gold Standard (1880-1914), Gold Standard (1918-1945), Bretton Woods (1945-1971) and post-Bretton Woods (1971 until now)). In particular, the rules of the Gold Standard and Bretton Woods systems are detailed and the mechanisms required for equilibrium adjustment are underlined. Despite the evolution of the international monetary system – the countries' economic and financial openness, the disappearance of common exchange rate rules - the problem of large disequilibria and the question of national monetary policy dependence still exist. Thus the objective is to shed light on these different exchange rate experiences and to underline the lessons that could be drawn from history. However, the main difference is that today, no explicit or implicit adjustment mechanism exists and the international monetary system is not governed by common rules. It seems then that industrialized countries prefer extreme exchange rate solutions (monetary union of free floating regimes) whereas transition or emerging economies choose intermediate exchange rate arrangements.

The second part proposes a detailed presentation of the different exchange rate arrangements (fixed, intermediate and floating) that can be chosen by countries. The authors stress the differences which exist in the implementation of *de jure* or official exchange rate regimes and *de facto* or applied exchange rate regimes and identify the main determinants of the exchange rate regime choices. *Fear of floating* situations are revealed in countries with strong institutions and a credible economic policy and *fear of pegging* ones in countries that suffer from a risk of unsustainability of their fixed exchange rate regime. More specifically, the optimal currency area perspective is studied from a static and dynamic point of view. The monetary union proposes an alternative exchange rate solution. The currency of the countries of the region is fixed to a common reference but this reference is flexible on international exchange rate markets. This monetary integration concerns the areas that have reached the third stage of the Bela Balassa (1961)[1] classification: the common market. The period preceding the adoption of this type of exchange rate solution is particularly long and difficult because it requires an economic, financial and political stabilization and integration of the countries of the region in order to ensure the sustainability of the future exchange rate regime.

[1] **Balassa, Bela**. 1961. *The Theory of Economic Integration*. Homewood, Illinois: R.D. Irwin.

In the light of recent crises, monetary union projects in emerging countries are taking on a new dimension raising two important questions. The first is to do with the *ex-ante* conditions necessary for setting up a fixed exchange rate arrangement in emerging countries which would be sustainable in the long term. The second involves looking at the regional aspect of the problem taking into account possible destabilizing shocks from neighbouring countries. In fact, the main problem linked to this type of monetary integration is due to external asymmetric shocks because the countries lose their national interest rate and exchange rate as instruments of adjustment in the event of shocks. This is particularly significant in emerging markets. The main condition for adopting a sustainable monetary union is the ability of the countries to resist these shocks. Respecting the traditional criteria of the Optimal Currency Areas theory (Robert A. Mundell 1961[2]; Ronald McKinnon 1963[3]; Peter Kenen 1969[4]) is not sufficient nowadays to protect countries against exogenous fluctuations. Today these studies must be completed by taking into consideration the changes that have taken place since the sixties in the international monetary system, particularly with the considerable opening up of financial markets and the extent of exchange crises in emerging economies. A study of "third generation" of crisis literature makes it possible to complete this set of criteria: in addition to the lasting stability of macroeconomic fundamentals, it is essential to consider the strength of the country's banking and financial sectors and the risk of illiquidity in a context of information asymmetry. This would help to avoid speculative attacks and the spread of financial shocks between countries in the same block during periods of international crisis (Giancarlo Corsetti, Paolo Pesenti, and Nouriel Roubini 1999[5]; Roberto Chang and Andres Velasco 2000[6]). But the numerous financial crises that occurred in emerging markets at the end of the last century - in Asia in 1997-1998, in Latin America in 1994, 1999 and 2001 and in Eastern Europe in 1998 and 2001 - have highlighted the inability of these countries to adopt this common exchange rate solution.

However, these episodes of crisis at the end of the last century have raised the question of the abandon of a fixed exchange rate in developing countries when they experience an outflow of capital and thus some pressure on their exchange rate during periods of international fluctuations. This problem makes it necessary to consider an exit strategy corresponding to the optimal moment to let the currency float. The accent is also put on the need to take into consideration political dimensions, in particular the influence of private interest groups, political institutions and the electoral process. These conditions are decisive in the choice of national and regional fixed and quasi-fixed sustainable exchange rate regimes.

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[2] **Mundell, Robert A**. 1961. "Optimum Currency Areas." *American Economic Review*, 51: 509-517.

[3] **McKinnon, Ronald.** 1963. "Optimum Currency Areas." *American Economic Review,* 53: 717-725.

[4] **Kenen, Peter.** 1969. "The Theory of Optimum Currency Areas: An Eclectic View." In *Monetary Problems in International Economy,* ed. Robert A. Mundell and Alexander K. Swoboda. Chicago: University of Chicago Press.

[5] **Corsetti, Giancarlo, Paolo Pesenti, and Nouriel Roubini.** 1999. "Paper Tigers? A Model of the Asian Crisis." *European Economic Review,* 43: 1211-1236.

[6] **Chang, Roberto, and Andres Velasco.** 2000. "Banks, Debt Maturity and Financial Crises." *Journal of International Economics,* 51: 169-194.

The third part focuses on the emerging countries' situation. The vulnerability of the countries that adopted intermediate exchange rate regimes during the last episodes of crisis and the inability to reconcile monetary independence, exchange rate stability and complete financial integration (*Mundell-Fleming* model) promote the two corner solution. But the analysis of the advantages and costs of each type of extreme exchange rate arrangement reveals that these solutions entail the respect of conditions which are too restrictive. In fact, the main advantage linked to a hard peg regime (*currency board*, *dollarization*) is the gain of credibility for the country, particularly when it is in a transition stage of development. The exchange rate risk between the country and its main partners is eliminated and this fosters an increase in trade and financial exchanges. However, the cost is very high because the country becomes totally dependent on the monetary policy of the country of reference which may not correspond to the needs of the domestic economy. Moreover, the sustainability of a fixed exchange rate arrangement involves respecting strict financial and banking rules, especially in emerging countries. Exchange rate stability requires the country to control the inflow of short-term capital, to limit foreign debt and to keep foreign currency reserves high in order to minimize its vulnerability on the international market. Besides, recourse to banking loans must be limited, as must be the spread between the lending and deposit rates, so as to guarantee the solidity of the banking system.

On the other hand, the flexible regime offers the possibility of reabsorbing the external disequilibrium by the exchange rate adjustment. But the independence gains depend on the risk of inflation due to depreciation of domestic currency and the vulnerability of the domestic interest rate to international fluctuations. Moreover, *the fear of floating* thesis reveals the negative impact of devaluation in emerging countries. Consequently, the accent is put on the revival of intermediate regimes in emerging economies.

Finally, the fourth part is devoted to the specific case of the transition economies that experienced different phases (stabilization, transition and preparatory) before joining the EU. This is based on an empirical analysis which represents an original approach in this book. These different periods are presented and detailed but the authors insist on the risks due to a large amount of short term capital inflows at the end of the first phase. They measure the advantages and cost of the timely abandon of exchange rate regimes as a nominal anchor during this phase when the countries experienced some pressure on their exchange rate regime (increase of current deficit, real exchange rate appreciation...). The analysis underlines the lower economic cost of adopting a transitory flexible exchange rate regime at a favourable moment rather than maintaining an unsustainable fixed exchange rate regime during this phase. The case of the Republic of Poland, the Czech Republic and the Slovak Republic that let their currency float are compared and particular attention is paid to the Serbian situation. The method selected is a VAR (Vector auto-regression approach) which is largely adapted to the study of the influence of the exchange rate regime and makes it possible to identify monetary transmission channels in the different cases (exchange rate targeting, intermediate exchange regimes and inflation targeting). The presence of a cointegration relationship between variables obliges the authors to use a VEC

approach in some cases. The results are derived from the interpretation of the variance decomposition and the impulse response function. In Poland, the change of nominal anchor has been well organized. The exchange rate pass-through is very low. Consequently, there is no need to influence exchange rate fluctuations, either directly with foreign exchange reserves or indirectly by way of the interest rate. On the other hand, in the Czech Republic the movement towards higher flexibility of the exchange rate has been difficult and impacted by important depreciation pressure. In this country, the highest exchange rate pass-through has been identified. The monetary authorities need to limit exchange rate variations both directly and indirectly, in particular through the interest rate channel in the case of inflation targeting. The transition towards a more flexible exchange rate in the Slovak Republic has been relatively well managed. The authors then focus their interest on the specific case of the Serbian economy. The exchange rate pass-through is high, especially when the exchange rate is the nominal anchor and in the period of managed floating (first and third). The country abandoned a *de facto* exchange rate as a nominal anchor policy and was faced with a complex situation at the beginning of 2008: the need for inflation targeting and the *fear of floating* problem. Thus different scenarios for the future evolution of the economy are proposed. The results therefore underline the fact that Poland is the only country that adopted a successful strategy of exchange rate regime transition. The strategy of the Czech Republic, the Slovak Republic and Serbia came too late. Consequently, the countries have experienced considerable real appreciation. Thus, to determine the right period for an exit strategy it is necessary to observe the growing ratio of nominal shocks (nominal price shocks) relative to real ones (productivity shocks) in order to explain real exchange rate variations.

Although, the book was written just before 2009, the authors conclude by placing the problem in the current crisis perspective and underline the main influence of the economic and financial evolution of developed countries on developing markets. A study of the impact of this crisis on emerging and transition economies according to the exchange rate regime in place could be the subject of a future book.

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