

Exchange Rate Regimes for the 21st Century: Asia, Europe and the Americas

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## EDITORIAL NOTE

**On Thursday, October 2, 2003, Professor James W. Dean of Simon Fraser University presented the paper which follows in the W. Irwin Gillespie Seminar Room of the Department of Economics, Carleton University, in a seminar co-sponsored by the Department of Economics and the Carleton Applied Economics Research Unit (CAERU), which is an organized research unit within the Department. CAERU is the successor to the Carleton Industrial Organization Research Unit (CIORU). The change of name reflects its broader mandate. Its purpose is to organize seminars, conferences, and other activities within the Department of Economics, with the intent of providing a forum for the activities of faculty and visitors in the area of applied economics research with a policy emphasis.**

**One of the outlets of the erstwhile CIORU was a working paper series, and it is with particular pleasure that we re-inaugurate this series, under the new CAERU imprimatur, with the current paper by Professor Dean. It sparked much interest and discussion in its 'live' presentation in the seminar, and we expect that it shall be equally as stimulating in print form.**

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## Exchange Rate Regimes for the 21<sup>st</sup> Century: Asia, Europe and the Americas

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It is commonplace today to assert that the world is becoming more globalized. But in many ways, including the movement of people, goods and capital, the world was almost as globalized during the three decades before the outbreak of WW1 in 1914. Immigrants moved by the millions from Europe to North America, and passports hadn't been invented. International trade in goods was almost as free as it is now, since Britain ruled the waves not to mention most of the colonized world. Tariffs, quotas and other barriers to trade were much less important than they became after 1918, and particularly after 1930. And capital moved freely in large quantities, from Britain and continental Europe to the developing countries of South and North America. The US was the world's biggest borrower, with Argentina and Canada not far behind.

One thing that was different then was that the world – or at least Britain and America's world - was on a gold standard. The gold standard broke down in the late 1920s and early 1930s and international trade and finance ground nearly to a halt. The cessation of trade compounded the great depression in Europe and the Americas, and the cessation of capital flows led to debt crises of magnitudes the world had never known – Latin America in particular defaulted on hundreds of millions of dollars of bonds held by North Americans and Europeans.

In 1944, the putative victors – America, Britain and a few dozen hangers on (like France) – met at the Washington Hotel in Bretton Woods, New Hampshire, to discuss reconstruction of world trade and finance after World War 2. They decided that the victors – Canada, Britain and the U.S. – should work toward the resumption of free international trade in goods: hence they founded the IMF to support fixed exchange rates via a “gold-exchange” standard, and lay the groundwork for the GATT, which is now the WTO. But free movement of both people and capital was put on the back burner.

One of the themes that will run through this talk is the implication of this back-burner role for capital for debt and currency crises over the past 21 years: 1982 – 2003. The architects of Bretton Woods did not have free capital movements in mind when they decided to set up a partial return to the gold standard. The essence of the Bretton Woods system was, first, to peg (but not irrevocably fix) prices of the world's major currencies to the U.S. dollar, and second, to fix, more or less irrevocably, the price of the U.S. dollar at 1 ounce of gold per 35 U. S. dollars. This system led to a few currency crises – the two most important were when Britain was forced to devalue twice against the dollar. But except in Latin America, which was

not fully part of the system, currency crises between 1950 and 1973 did not debilitate economies for months or even years at a time.

In 1973, the Bretton Woods system collapsed and the world's major currencies – notably the dollar, the Deutsch Mark and the yen – began to float freely against one another. 1973 also saw another epochal event: a massive increase in the world price of oil, engineered by OPEC countries feeling their oats for the first time. The connection between these two epochal events is that OPEC's oil price hike ushered in a new era of large-scale capital mobility that coincided with a new era of exchange rate flexibility. Their coincidence was by no means accidental: OPEC was able to hike the price of oil and get off with it because the US balance of payments deficit – itself a byproduct of fixed exchange rates and an inflationary Vietnam war – had flooded the world with US dollars and generated inflation in Europe and other oil-importing parts of the world. In short, the oil price hike would not have succeeded had not the world been awash with dollars. And the Bretton Woods system of exchange rates pegged to the US dollar also collapsed because of the US deficit: to make its exports competitive again, the US needed to devalue. Other countries like Germany needed to revalue because they were running surpluses and being forced to accumulate US dollars.

But not only did the oil price hike and the move to flexible rates have a common cause – the US balance of payments deficit – they had common consequences. The oil price hike ushered in a new era of large-scale international capital mobility, an era that is still very much with us. Oil-exporting countries began to lend on an unprecedented scale to oil-importing countries. The lending and borrowing was intermediated through international banks located mostly in London, but also in New York. They operated mostly in dollars: the term “Eurodollars” came to mean deposits and loans outside the US but denominated in US dollars. Eurodollar and other “Eurocurrency” lending (mostly in DM and yen) soon moved beyond just oil-importing countries. National savings from OPEC as well as US and European countries soon found their way, via Eurocurrency lending that was syndicated between large US, Canadian, European and Japanese banks, to rapidly growing, middle-income developing economies – what we would call today “emerging markets”. These economies were in Southeast Asia, Eastern Europe and, most importantly, Latin America.

In August of 1982, Mexico abruptly stopped payments on its international debt. Within a few weeks, the world's big banks, fearing similar arrears throughout the indebted developing world, stopped lending to all of Latin America and much of Southeast Asia and Eastern Europe. In Latin America the debt crisis led to seven “lost years” – 1982 – 1989 – when growth ground to a halt, investment turned negative, consumption collapsed, real wages plummeted and poverty skyrocketed. In Southeast Asia, by contrast, except for the Philippines, indebted countries like South Korea tightened their belts: they devalued their exchange rates, increased their savings rates and managed to repay their substantial foreign debt without emergency lending from the IMF and without receiving write-offs from their

creditors, which were largely Western and Japanese banks. In Eastern Europe the debt crisis contributed to Solidarity's victory in Poland in 1989, triggering the collapse of the Berlin Wall that same year, and the collapse of communism throughout Eastern Europe and the Soviet Union in 1990 and 1991.

In short, the resumption of international capital mobility in the 1970s had an upside and a downside. It financed rapid growth in East Asia, Eastern Europe and Latin America. But it also led to serious debt crises in the 1980s, when the borrowers could not repay the money they owed. East Asia recovered quickly, but Eastern Europe and Latin America did not. Does this mean that international capital mobility is a bad thing?

No economist would argue that capital mobility in general is a bad thing. Moving capital from low-return investments in developed countries (or rich ones that are oil exporters) to high-return investments in developing countries, must, in principle at least, be beneficial to both lenders and borrowers. But in practice it often happens that too much is borrowed and lent at first, and that this leads to a repayment crisis, which in turn leads to too little borrowing and lending after the crisis. In short, over-lending is followed by a debt crisis, and then under-lending.

There is an entire academic industry that tries to explain over- and under-lending. In recent years, a growing part of this industry invokes psychology: "behavioral" finance has now become mainstream and respectable. This I will not discuss here. Rather I will move from crises of capital flows to crises of exchange rates – that is I will move from debt crises to currency crises. The two of course are intimately linked.

The 1990s and the early part of this century have seen an unprecedented number of currency crises, often preceded by, associated with or followed by debt crises. A currency crisis means a sharp fall in the foreign-currency value of a country's domestic currency. They are important because they usually, and almost always in "emerging economies", have severe "real" consequences: output drops, unemployment rises, and so on. Major currency crises in emerging economies include Mexico in 1994, Thailand, Malaysia, Indonesia and South Korea in 1997, Russia in 1998, Brazil in 1999, Turkey in 2001 and Argentina in 2002. Most economists believe that many currency crises could be averted, or at least their consequences ameliorated, by adopting different "currency regimes" than those that have typically prevailed since 1973.

The problem is that economists differ widely on what is considered an ideal currency regime to avert crises. Some believe that only fully flexible rates can avert currency crises, while others believe that only very credibly fixed rates (preferably constitutionally fixed, via a "currency board") can avert crises. Still others believe that no fixed rate can avert crises entirely, and advocate eliminating the exchange rate entirely, either by adopting a new currency in common with other countries, as 12 European countries have done via the euro, or by adopting someone else's

**currency, notably the dollar or the euro: this is known as “dollarization” or “euroization”. However most economists do not subscribe to a “one regime fits all countries” philosophy – that is, we recommend flexible rates for some and common currencies or dollarization for others. And most recently, a growing minority of economist has begun to advocate “intermediate” regimes.**

**After the currency crises of the mid-1990s, many economists formed a consensus on one exchange rate regime principle: “automaticity”. Flexible rates, common and external currencies, and to some extent currency boards, share a common feature: changes in the exchange rate (under flexible rate regimes) or in the money supply (under fixed, common or external-currency regimes), are “automatic” in the sense that they respond only to market forces or to exogenous, non-government shocks. They are not subject to direct manipulation by domestic governments (although monetary and fiscal policies affect flexible exchange rates even though that may not be their intention). By the end of the 1990s the consensus among many if not most economists was that many if not most currency crises result from speculation against “pegged” regimes that fix exchange rates for periods of time but that leave open the possibility of devaluations or revaluations engineered by domestic governments. This consensus argues that much of the speculation that successfully “unpegs” such currencies is, in effect, speculation against the ability or willingness of domestic governments to maintain an exchange rate peg.**

**Of course the Bretton Woods system consisted, essentially, of just such pegs. But although it led to many currency crises, they were neither as deep or as debilitating as those we saw in the 1990s. Why, then, is “automaticity” needed now?**

**Answers to this question are of two types. One type of answer accepts that Bretton Woods more or less worked but argues that it outlived its time. The second type of answer starts from the premise that Bretton Woods never worked well. The incompatibility of these answers illustrates once again that economists never cease to disagree, even (or perhaps especially) about administration of the exchange rate, which (along with the interest rate) is one of the two key prices of a modern economy.**

**The first type of answer runs like this: The Bretton Woods system actually worked much better than anything has since. With exchange rates more or less stable and predictable, international trade increased multi-fold. One factor that made it work was cooperation between countries with the three major exchange rates that dominate international trade and finance: the U.S., Europe (notably Germany) and Japan. For example Germany cooperated by accumulating U.S. dollars to prevent appreciation of the DM; the U.S. lent dollars to England when the pound sterling was in trouble; so too did the IMF, as intended under the Bretton Woods arrangements. Moreover in the post-Bretton Woods era, the European Monetary System of exchange rates more or less fixed against the Deutsch mark worked because Germany and France cooperated, mostly to buy French francs or Italian lira when necessary.**

**But one thing that has changed dramatically since Bretton Woods began, and particularly since it collapsed in 1973, is that international capital flows have increased multi-fold. It is a truism of open economy macroeconomics (but one that was not obvious to most before Robert Mundell's classic articles of the 1960s) that fixed exchange rates are compatible with a country's ability to control its own monetary policy only if capital is not free to flow.<sup>1</sup> Otherwise countries must allow their exchange rates to respond, often quite substantially, to inflows and outflows of capital if they want to control their own money supplies rather than leave them to the vagaries of capital flows. Hence under fixed exchange rates or common currencies countries must give up independent monetary control, or at least cooperate on monetary and fiscal policies and sacrifice their own immediate objectives. The euro, yen and dollar zones must cooperate on macroeconomic policies so as to reduce swings of their currencies against each other, swings that can and have led to serious misallocation of resources and loss of output over the past 30 years since Bretton Woods collapsed. This, roughly, is the position taken by the Godfather of modern open economy macroeconomics, and winner of the Nobel Prize, Robert Mundell. In fact Mundell, ever the visionary, foresees a "world currency".**

**A radically different version of the pro-fixed-exchange-rate view is that since Bretton Woods more or less worked when capital flows were limited, we should return to such a world by deliberately restricting capital flows. While this view may have some merit for emerging economies with fragile banking systems, it does not, in my view, and that of most economists, hold for the developed-currency-blocks of the yen, the euro and the dollar.**

**A second view is that Bretton Woods was fundamentally flawed from the outset. Flexible rates make monetary independence and capital flows compatible, and in addition help to insulate countries from external shocks that would otherwise result in unwanted increases or decreases in the money supply and thus inflation or unemployment. That, roughly, is the position that has been taken for decades by another Nobel Prize winning economist, Milton Friedman.**

**In short, two of the last century's most prominent economists<sup>2</sup> advocate apparently opposite prescriptions for the relationship between the world's three big currencies: Friedman advocates flexible; Mundell advocates fixed.**

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<sup>1</sup> Ever the contrarian, Mundell himself has recently begun to repudiate this "Impossible Trinity", suggesting that monetary policy simply amounts to a choice between fixing a price (the exchange rate) or a quantity (the money supply, or its surrogate, the overall price level). A corollary is that "independent" monetary policy *is* consistent with free capital flows, but only so long as the monetary policy either fixes the exchange rate or fixes the price level (or its rate of change, the inflation rate). Hence the monetary policy which is currently fashionable, "inflation targeting", is indeed compatible with free capital flows, and such policy, roughly, will stabilize the exchange rate. I view this line of reasoning as playing with words.

<sup>2</sup> In October 1999, after the Nobel announcement, the Wall Street Journal proclaimed Mundell more influential in the 20<sup>th</sup> century than Keynes.

So much for exchange rates *between* the world's major currencies. In closing I will turn briefly to four areas of the world – the Americas, Europe, Eurasia and Asia – and outline very briefly the pros and cons of currency cooperation *within* the regions rather than between them.

### The Americas

As you know, here in Canada several prominent economists advocate adoption of the US dollar. And in Latin America, Ecuador, El Salvador and Guatemala have all, since 1999, adopted the US dollar as their official currency. Argentina proposed the idea to the US Treasury in 1998 but got somewhat short shrift from Larry Summers. In my opinion, Ecuador, with its out-of-control inflation, was wise to adopt the dollar. Argentina would have been less wise: first because by 1998 it had inflation well under control, and second because its economy is relatively closed to international trade, and what trade exists is more with Brazil, Europe and even Japan, rather than the U.S. Canada on the other hand is certainly is open, with over 40% of its GDP internationally traded and about 85% of its exports and imports with the US. But Canada has one of the world's most conservative central banks, more conservative than the US Fed, and hence has no recent history of inflation. The case for adoption of the US dollar is mixed.

### Europe

Twelve countries in Europe have embraced the euro, probably permanently<sup>3</sup>. Denmark, Sweden, Norway and Great Britain have thus far eschewed the euro. In 1992, the Danes held a referendum that rejected the euro. Very recently, on September 14, 2003, the Swedes held a referendum and resoundingly rejected it. Simple nationalism plays a strong role in both Denmark and Sweden, but the Swede's rejection also reflects a popular desire to defend their welfare state against erosion by Brussels. Norway, which is oil rich, wishes to defend its oil revenues against Brussels' budget demands and has not even joined the European Union. Also, Norway's dependence on oil, and the price of oil, warrants an exchange rate that can adjust downward when the oil price falls: a similar argument can be made for other resource-exporting countries like Australia and Canada.

Britain's rejection reflects an economy that is both structurally different from the continent, and at a different stage in the business cycle. Moreover, British homeowners, unlike continental European, are typically dependent on floating rate mortgages and thus are worried that they might potentially be victimized sometime in the future should the continent call for high rates at the same time that the British business cycle is in downturn. Just that did indeed happen in 1991-92, forcing rates

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<sup>3</sup> However *The Economist* magazine (June 11, 2003) recently ran an article, albeit slightly tongue-in-cheek, suggesting that Germany should withdraw from the straightjacket of the euro!

up so high the British were forced to abandon their peg to the European Currency Unit.

The recent Swedish referendum may well prove a watershed. Just a few months earlier, in May 2003, the British Treasury recommended postponement of entry into European Monetary Union, partly on grounds that interest rates, inflation etc. are still out of synch with the continent. But the British popular opinion is also anti-euro for reasons similar to the Scandinavians': a desire to defend national policies against intrusion by Brussels. (Ironically, the British, by and large, worry that Brussels might impose socialism, in contrast to the Swedes, who worry about the opposite!).

What about the smaller currencies in Europe? Ten Eastern and Central European countries are scheduled to join the European Union next year. By 2007 or 2008, all ten will almost certainly adopt the euro. Two of these – Estonia and Lithuania – already have hard fixes to the euro via currency boards. So too do Bulgaria, which hopes to join the EU in 2007, and Bosnia. Kosovo and Montenegro have simply adopted the euro unilaterally, without waiting for permission from Frankfurt or Brussels. It is not inconceivable that Bosnia, Croatia and Serbia might do so too.

### Eurasia

We now look still further east, to countries that (with the exception of Turkey) may never join the European Union, let alone the European Monetary Union. Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Russia, Turkey and Ukraine are all heavily dollarized, not euroized, but informally, not officially – that is the US dollar is widely used for transactions and/or held as an asset to hedge against inflation. For example the value of US dollar currency held in Russia is an astonishing 80% of the value of ruble currency. Russia is not likely to dollarize officially, not least for reasons of national pride and hubris: nor is Ukraine. But official dollarization or euroization is a possibility in the other seven Eurasian countries, and they might well undertake it *unilaterally*, that is, without permission from Brussels or Frankfurt.

### Asia

Last but not least we come to Asia. East Asia's agenda for monetary and exchange rate cooperation is embryonic by comparison with Europe's. Little of practical import has been implemented, with the exception of the "Chiang Mai Initiative" of 2001 that provides a formula for sharing a very small fraction of the region's foreign exchange reserves. Indeed, monetary and exchange rate cooperation in the region was not even contemplated or discussed before the 1997 financial crisis. The 1997 crisis embarrassed East Asia by putting it in a position of dependence on the IMF and the U.S. for foreign exchange bailouts, even though Japan, China, Taiwan, Hong Kong and Singapore together account for most of the world's foreign

exchange reserves. Cooperation could in principle have relieved East Asia of any dependence whatsoever on Washington.

From a series of studies commissioned by the Asian Development Bank and published in 2002, three options for exchange rate coordination emerged:

1. Creation of an “Asian Currency Unit” (ACU) that would tie individual Asian currencies to each other while allowing the ACU to float against external currencies, modeled on the former European Currency Unit (ECU).
2. Stabilization with respect to a basket made up at least partly of extra-Asian currencies: either a peg to the basket (Ogawa and Ito) or a band around it (Frankel). Frankel suggests a peg to the Singapore dollar, since it already pegs to a basket of the big three: dollar, euro and yen. A second virtue of a peg to the Singapore dollar is that it is a real, fully-convertible and functional currency, not a virtual currency like the putative ACU. And Singapore’s exchange rate regime is perhaps the world’s most successful example of what John Williamson calls a “BBC” (Basket, Band and Crawl) exchange rate regime.
3. A peg to a single currency such as the yen or the dollar. Ronald McKinnon proposes the dollar.

In my opinion, none of these three options is even remotely feasible in the near future, not least for political reasons. What *is* feasible is what Eichengreen calls an “Asian Financial Institute” (AFI), built on the platform of ASEAN + 3<sup>4</sup>. The AFI would provide technical assistance to national agencies on prudential supervision and regulation. It would run training programs and encourage information-pooling. It would also provide reserve management, clearing and settlement services to member central banks, much as the Bank for International Settlements provides for its members. And an Asian settlements system would obviate the need to clear using U.S. and European settlement systems, as is common at the moment.

Building on the platform of ASEAN + 3 could take advantage of the existing infrastructure of regular meetings and an extant pool of financial resources. Moreover the AFI could be connected to the Chiang Mai Initiative (CMI) for reserve sharing, but with the clarification that the CMI is not intended to stabilize exchange rates but rather to foster *financial* (notably, banking) stability. Bilateral swaps under the CMI would be available under crisis circumstances: stock market collapses, banking panics, or currency collapses. ASEAN + 3 would in effect act as a lender of last resort to countries whose financial systems were at risk, with conditions attached. In short, the region would cooperate on financial standards and regulations, and also cooperate to provide limited financial assistance for countries that have difficulty adjusting to those standards.

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<sup>4</sup> ASEAN + 3 is China, Japan and Korea plus the ten countries in ASEAN.

Eichengreen argues for financial cooperation on three grounds. First, East Asian countries share common financial characteristics: high reliance on banks, high corporate debt-equity ratios, and close connections between industry, banking and government. These characteristics proved problematic in 1997 and were in good part responsible for the financial crisis<sup>5</sup>. He suggests that the region should pool information, analysis and expertise on these problems.

Second, since the Asian financial “model” may be distinct, there may be a case for bank regulations distinct from those promulgated by the Basle Committee of Bank Supervisors, or for corporate governance standards that take into account the prevalence of family controlled firms and thus protect minority shareholders in other ways than installing outside directors.

Third, intensified inter-country competition in the region – for example between Singaporean and Malaysian banks, or between Hong Kong and mainland Chinese banks – could lead to a “race to the bottom” in capital requirements and the like: hence a need for regional cooperation, just as there was a need 20 years ago for the international cooperation that led to the Basle Capital Accord of 1988. And since Asian characteristics are distinctive, the Basle Committee’s Capital Standards and Core Principles for Effective Banking Supervision do not suffice.

It is indicative to compare the spirit of the Eichengreen proposal with official reality. I reproduce below an excerpt from Asian Development Bank’s website:

*At the present time, the informal surveillance system that is in existence among the ASEAN+3 countries and their central banks is deemed adequate to oversee the operations of the CMI. The only efforts being made at an institutional level are to establish early warning systems and to monitor short-term capital flows. Once the BSA [Bilateral Swap Agreements] network is completed, and more so, if a decision is made to multilateralize the BSAs, there may be a need for a more formalized and rigorous surveillance including developing conditionality for the proposed reserve pool (similar to the European Monetary Cooperation Fund that existed in Europe in the 1970s).*

Source: [http://aric.adb.org/docs/CMI\\_rev.pdf](http://aric.adb.org/docs/CMI_rev.pdf)

### Conclusion

In short, we economists disagree about ideal currency regimes, as we do about much else. Moreover the world in practice is even more disagreeable, in the sense that only a small minority of the world’s exchange rate practices conform in the slightest to the idealized regimes envisaged by most economists. Most of the world’s regimes are neither fully flexible nor fully fixed. The most important examples of

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<sup>5</sup> So called “third generation” currency crisis models, in vogue since the East Asian events of 1997, typically invoke these characteristics and often proceed by analogy with bank runs: countries with high ratios of short-term debt to international reserves experience “runs” when their creditors decide not to roll over short-term loans; moreover these “runs” are contagious between countries.

more-or-less free flexibility are the dollar, euro and yen, and the most important examples of fully fixed are the Chinese yuan and the Hong Kong dollar. But in practice most countries in the world run so-called “intermediate” regimes, often regimes that are declared by their governments to be flexible but that undergo a good deal of intervention. The IMF now publishes a second, alternative classification of exchange rate regimes that reflects practice rather than official declarations of intent. Several of the post-crisis East Asian economies – Korea, Indonesia and Thailand, not to mention Singapore and Taiwan – are prime examples. In such countries, the central bank intervenes heavily to stabilize exchange rates, both in the short and medium run, but not heavily enough to prevent secular movement up or down, or, from time-to-time, sharp changes, particularly devaluations.

Are intermediate regimes as unstable as proponents of the two extremes – fully flexible and fully fixed, preferably via a common or external currency – have been arguing for the past decade? A surprising number of economists – for example, Max Corden, Barry Eichengreen, Stanley Fischer and Thomas Willett - are beginning to conclude “not necessarily”. In fact a few – Jeff Frankel and, notably, John Williamson - have argued for more pragmatism all along.

Can any conclusion at all be drawn from the controversy and eclecticism I have just chronicled? Though to the naked eye the answer would seem “no”, that answer is too simple and too pessimist. Here are the conclusions that I think can be drawn. Of course not all economists would agree!

1. *No one size fits all.* There is no one-size-fits all optimal exchange rate regime; ideal regimes vary country by country. For example a country with hyperinflation might ideally adopt a stable foreign currency, as might a country whose trade and/or capital flows are dominated by that foreign currency. Moreover the ideal regime for a particular country might change over time. A currency board to cure inflation might ideally evolve into a more flexible regime – although that poses problems of credibility, or more precisely how to preplan an “exit” from the regime without undermining credibility from the start. Countries in transition from planned to market might similarly evolve through stages, from fixed (to whip inflation as soft budget constraints persist) to flexible (as capital begins to flow in, big-time) and then back to fixed again (as joining the euro becomes imperative). Poland, Hungary and the Czech Republic more or less evolved through stages one and two in the 1990s, are all converging to stage three in the 2000s. The Czech Republic was too dogmatic and stuck with its first-stage, fixed rate for too long, prompting a currency crises in 1997.
2. *Pragmatism not dogmatism for flexible regimes.* The extreme options – fully flexible regimes, or immutably fixed regimes (including the adoption of common or external currencies) - are, for most countries, less than ideal. Fully flexible regimes need to be accompanied by some anchor for

monetary policy, at the very least an inflation target. Flexible rates with inflation targets are currently fashionable, both in theory and in practice. However they generally need to be accompanied by pragmatism. Consider four prominent flexible rate regimes. The Bank of Canada, under John Crow a pioneer of inflation targeting in the late 1980s, was much too single-minded and, in my judgment, cost the country several years of lost output and unnecessary unemployment by targeting a rapid and uncompromising reduction of the inflation rate to one or two percent. The U.S. Fed, under Greenspan, was far more pragmatic. The Fed accepted a higher inflation rate, and also “fine-tuned” monetary policy (an unpopular concept since the advent of “monetarism”). Monetarism, by which I mean money-supply-targeting, worked well under Volker to break inflationary expectations in the late 1979- 81, but was unnecessary after that. The third major flexible regime is Japan’s. The Bank of Japan has been so fearful of inflation that, to this day, with deflation dangerously settling in, it refuses to target positive inflation. The fourth regime, euroland, like Canada in the late 1980s and early 1990s, and unlike the US Fed, dogmatically targets inflation to the exclusion of real output. Flexible regimes need to target not only inflation but short-term deviations of output from target as well.

3. *Pragmatism not dogmatism for fixed regimes.* Hard fixes or common currencies don’t always work either. Argentina’s hard fix to the US dollar collapsed in the absence of a credible exit option. And Europe’s common currency is crucifying Germany, which desperately needs lower interest rates than are ideal for the rest of euroland.
4. *Intermediate regimes are not the source of all evil.* The fact that many if not most countries of the world run intermediate regimes should tell us something. Post-crisis East Asian countries like Korea, though ostensibly (except for Hong Kong, China and Malaysia) on flexible rate regimes, nevertheless understand the need to moderate appreciations or, like Greenspan’s Fed, understand the need to respond pragmatically to increases in inflation or decreases in output growth. Moreover many countries run fixed regimes that are pragmatically flexible: notably, and with great success, Singapore and its “Basket, Band and Crawl”.
5. *“Optimal” exchange rate regimes are never a panacea for countries facing bad “fundamentals”.* Hence in the 1960s and 1970s, Latin American fixed-rate regimes regularly collapsed because they allowed inflation to run ahead of their trading partners’. In the 1980s, currencies collapsed in middle-income, highly-indebted countries because debt payments were unsustainable. In the mid-1990s, European pegs to the ECU were unsustainable because they faced German interest rates that were too high for the rest of Europe (ironically, the reverse is true now). In the

mid-1990s, Mexico's peso peg to the dollar collapsed because capital inflows were not sterilized on the way in but were sterilized on the way out. In 1997, East Asian currencies collapsed because capital inflows had been misallocated through "crony capitalist" banks. In Russia the *ruble* peg to the dollar collapsed because of a fiscal crisis that led to unsustainable debt payments; so too Brazil's *real* peg collapse in 1999. In 2001 Turkey's active crawling peg collapsed because of fiscal pressure on both inflation and debt, and because of political leadership that was too weak and divided to implement reforms. And in 2002, Argentina's hard fix of the peso to the dollar collapsed because external debt payment had become unsustainable, and because credible exit from the "Convertibility Plan" was bungled (an alternative would have been credible strengthening of the compromised currency board that underpinned the hard fix, or, most credibly, dollarization).

All these are examples of exchange rate regimes that were perfectly feasible in principle but that co-existed with weak fundamentals: high inflation; unsustainable foreign debt; high interest rates to maintain a peg when internal balance (between aggregate demand and aggregate supply) demanded the opposite; asymmetric sterilization of the money supply in response to capital inflows and outflows; incompetent, "crony" or corrupt domestic banks; chronic fiscal imbalance; pegs to currencies rising against trading partners; and ill-conceived, non-credible exits from hard fixes.

The debate over ideal exchange rate regimes is the oldest and most central debate in open-economy finance. As the world turns, so too does the debate. But the debate will never end, nor will our fascination with international finance.

## SOURCES

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