

Exchange Rate Regimes for Accession Countries

Willem H. Buiter*

Member, Monetary Policy Committee, Bank of England
Professor of International Macroeconomics, University of Cambridge and
Chief Economist Designate, European Bank for Reconstruction and Development

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In this brief talk I hope to make use of the insights gained during my soon-to-be past life as a member of the Monetary Policy Committee of the Bank of England to reflect on a key issue confronting all countries of operation of my soon-to-be employer, the European Bank for Reconstruction and Development. The issue will be the appropriate exchange rate arrangements for the 26 transition economies that constitute our area of operations.

Before turning to the question as to what the exchange rate arrangements ought to be, a quick glance at current practice is in order. Table 1 shows the wide variety of exchange rate arrangements found in our area of operations.

Table 1 here.

Of the EBRD's 26 countries of operations, five float 'freely', twelve have a managed float, one has a crawling peg, three have a de-facto 'conventional' fixed exchange rate, four have a currency board and one has a managed float with multiple exchange rates.

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Managed floats cover a wide spectrum of possibilities. There is no suggestion that a managed float is necessarily well-managed. A free float is also hard to define precisely. Any debt management action by the central bank or the government can have effects on the exchange rate. Of the four currency boards, one is tied to the US dollar and three are tied to the Euro. The three fixed regimes include two Euro pegs and an SDR peg.

In addition to having differing exchange rate regimes, our countries of operation have widely different approaches towards the international mobility of financial capital. The range is from effectively unrestricted to almost completely inhibited. Both administrative and fiscal impediments to international financial integration are widely used.

What is the appropriate exchange rate regime for each of our countries of operation? According to conventional optimal currency area theory, the answer will depend on country size, on economic structure, including openness and degree of economic and financial development, on the degree of cross-border mobility of labour, real capital and other productive resources and on the importance and persistence of *nominal* price and cost rigidities. The answer is unlikely to remain the same even for any one country as it moves along the transition path. How one judges various exchange rate arrangements also depends on how one views the feasibility and desirability of controls on the international movement of financial capital.

I will deal with the one easy regime first - the multiple exchange rate regime. I can think of no circumstances under which efficiency, stability or fairness are well-served by a multiple exchange rate regime. Such a regime is a definite economic and political-economy no-no. When the same commodity is bought and sold at wildly different prices, bad things

happen. Multiple exchange rates distort, corrupt, invite patronage, cronyism and favouritism. They create incentives for costly rent-seeking. They are likely to lead to serious quasi-fiscal deficits for the central bank charged with managing the multiple exchange rate regime, and often forced to engage in sell low/buy high strategies. There is no excuse for operating this worst of all possible regimes.

The rest is harder. Let's see whether we can learn something from the experience during the past couple of decades of the advanced industrial countries. For the advanced industrial countries, all of which are by now fully integrated into the international financial system, two clear trends are emerging. First, there are only two viable currency regimes, located at the extreme ends of the spectrum. These are free floating and a common currency, that is, monetary union. Second, there are going to be fewer and fewer currencies. Within a decade or two, the advanced industrial countries will have 2.5 currencies among them: the Euro, the US\$ and something around the Yen or the Yuan.

Second, all intermediate regimes, fixed-but-adjustable exchange rates, crawling pegs, actively managed floats etc. are accidents waiting to happen and cannot survive for long. Only credible fixed exchange rate regimes are viable. I believe that, in the long run, the only credible and viable fixed exchange rate regime is a common currency. This can be either a (formally symmetric) monetary union, or the unilateral adoption of another country's currency as the only form of legal tender by another country, that is, dollarisation or euroisation. A currency board is the poor man's monetary union or a fixed exchange rate regime that tries harder. It may survive for a while, as a half-way house to full monetary union. The same may hold for conventional fixed exchange rates regimes, provided the defence of the external

parity is given a higher priority than the pursuit of domestic objectives such as price stability or the elimination of the domestic output gap. The Netherlands and Austria during the two decades before they joined EMU are examples of such credible fixed rates vis-a-vis the DM. It is no accident that both examples involve small open economies maintaining a currency peg with their large main trading partner.

As a rule, unrestricted financial capital mobility makes short work of the intermediate exchange rate regimes. A free float is viable, that is, survivable, but dominated, economically, by a common currency. Under a regime of unrestricted financial capital mobility, the exchange rate is not so much an effective shock absorber, which buffers the real economy from fundamental shocks arising at home or abroad, but rather a source of shocks, instability, persistent real exchange rate misalignment and excess volatility. Monetary union, the logical economic implication of full financial integration, requires a significant degree of political integration and political union, however.

The decision of the UK government not to join EMU on January 1, 1999, was, in my view, a grave mistake - a historic error of judgement. The Pound Sterling is now uncomfortably lodged between the two currency elephants, the US dollar and the Euro. The view of a floating exchange rate as an effective buffer or shock absorber has proven particularly untenable for the UK. With an operationally independent central bank and a government-mandated inflation target, the exchange rate has proved to be a bit like a rogue elephant. The effective exchange rate of the Pound Sterling has appreciated spectacularly since 1995/6, causing a painful imbalance between the internationally exposed sectors and the internationally sheltered sectors. Any attempt to drive the pound down significantly

through monetary policy actions would, if it were successful, undermine the inflation target. If the UK stays outside EMU, it is bound to see before too long an episode with a spectacularly undervalued Pound Sterling.

The main proximate source of trouble, and the main contributor to the seriously overvalued effective exchange rate of Sterling has been the strength of Sterling vis-a-vis the Euro. Euroland accounts for 50% of UK exports and imports. If the nations shadowing the Euro are added, this share gets up to close to 60%. To have large, asset-market induced swings in the nominal and real exchange rate vis-a-vis one's main trading partner is not a recipe for a comfortable life. Joining EMU, at a significantly more competitive exchange rate than the current one, would be a far superior option for Britain. It is a real option, because the EU (just about) provides the minimum supranational institutional and governance structures necessary to make a monetary union with Euroland a politically viable arrangement. Stronger supra-national, Federal institutions would, however, strengthen the authority of the ECB.

What lessons are there in this experience for the transition countries?

First, let us consider those countries for whom accession with the EU, let alone membership in EMU, are at best a very distant vision. Joining in a monetary union with one of the supercurrencies is not an option. The political and constitutional pre-conditions are not satisfied. The same holds for membership in a monetary union among the much delayed transition countries. Quite apart from its lack of economic merits, such a regime would not be politically viable. One needs at least a confederal and preferably a federal political structure to make a monetary union work.

If capital controls can be made effective, a number of options, ranging from a currency board (probably with the Euro, or vis-a-vis a basket of currencies in which the Euro has the lion's share), via a fixed-but-adjustable peg or a crawling peg, with or without a band, to a managed float and a free float are sustainable, given a supportive fiscal and monetary regime. If capital controls cannot be made effective, or are deemed undesirable, there are only two options, a credible fixed exchange rate regime or a free float. A currency board is probably the most credible fixed exchange rate regime, although anything that has been created politically can also be unmade politically.

A currency board has two key features: an irrevocably fixed exchange rate and the prohibition of domestic credit expansion by the central bank. The entire monetary base is backed by international reserves. Effectively, the foreign currency, let's call it the Euro, becomes legal tender domestically. There are several advantages, all of which depend on the currency board arrangement being perceived as credible and permanent.

The first advantage is that you will save some money, because you don't need a central bank in its capacity as the monetary authority. Banking supervision and regulation is of course still required. The role of domestic monetary policy is so circumscribed, that only the most rudimentary central bank is required. You need a chap at the foreign exchange window, exchanging domestic currency for Euros and that's about it. Of course, domestic interest rates must be kept at the same level as Euro rates, after allowing for a default risk premium, but in all but the most underdeveloped financial systems, markets will take care of that.

The second advantage is that you throw away the key to the drawer labelled ‘monetary financing of government budget deficits’. In a well-run economy, that would actually be a drawback. Seigniorage can be an important source of revenue for cash-strapped governments. There is no reason to believe that the inflation rate generated under a currency board is anywhere near the optimal rate from a neoclassical public finance point of view.

However, political economy considerations, distilled from the raw lessons of history, suggest that the printing press is a great seducer, and that the freedom to issue monetary liabilities at will is likely to be abused. An independent central bank, either an instinctively conservative one with both operational and target independence, or a central bank with just operational independence, but dedicated to an externally imposed mandate of price stability, would, in principle, prevent such abuses. This, however, begs a number of key questions. Can the political realities support an operationally and target-independent central bank? Would price stability be the overriding target of a target-independent central bank? How would an operationally central bank internalise an externally imposed price stability mandate? And who would impose such a mandate on the central bank?

In many transition countries, the central bank is not even nominally independent. Where it is nominally independent, it is often not effectively independent. This problem is compounded by the fact that the central bank in a number of transition economies does not limit itself to conventional central banking roles (monetary policy and supervision and regulation of the banking and financial systems), but also acts as a development bank and performs commercial roles. That way lies the road to disaster. | Central banking functions

and development banking functions should be institutionally separated. Both are important, but the two don't mix. A central bank that engages in commercial financial activities is in even deeper water. There is clear conflict of interest between the central bank as regulator and supervisor and the central bank as a commercial market player.

Central banks should, under normal economic conditions, only provide credit to the general government, and possibly only to the central government. Central banks do not have the knowledge or operational capacity to make do the cost-benefit analyses that are central to development banking, nor do they have any special talent for making commercial banking or investment decisions. If the government wishes, for whatever reason, to extend credit, on market or below-market terms, to the private sector or the state enterprise sector, it should do this through a separate institution, funded by the government (through the Treasury). This 'development' bank should not be able to call on the central bank for financial support, through capital grants disguised as loans. Transparency and accountability are served by shifting all quasi-fiscal operations of the central bank into the central government budget, where they belong.

Of course, a central bank has a lender of last resort function in times of financial crises that pose a serious systemic risk to financial and macroeconomic stability. Under such circumstances the central bank should lend freely, against the best available collateral, and at punitive rates. If a liquidity crisis becomes a solvency crisis, the central bank does not have the resources to act effectively. Only the state, through the Treasury and its power to tax, has the resources to recapitalize insolvent financial institutions.

One obvious drawback of a currency board is that there can be no lender of last resort, since domestic credit expansion is ruled out. There may be ways of partially privatising the lender of last resort function by arranging contingent credit lines, but the scope for that is inevitably limited in the countries under consideration.

If a country opts for a currency board, it should peg to a currency or to a basket of currencies that accounts for the lion's share of its external trade. For most transition countries, the Euro or a basket with a large Euro share, will be the natural choice. Pegging to the US dollar or even to the SDR, is an open invitation for trouble.

A currency board makes the most sense for small, highly open countries whose external trade is highly concentrated in a particular hard currency.

Unlike a currency board, a floating exchange rate regime cannot break down. That does not mean it will contribute much to macroeconomic stability. Under conditions of free capital mobility, the exchange rate is a source of shocks and instability more than it is a mechanism for adjusting more effectively to internal or external shocks. Despite this, it may well be the only viable option for the larger and less open transition economies that are still a very long way from accession..

The accession countries (and those aspiring to become accession countries in the reasonably near future) face a rather limited choice. Most of these countries have liberalised their capital accounts to a significant extent. It is true that qualifying for EU membership does not preclude the presence and use of capital and exchange controls either as a transitional arrangement or under exceptional circumstances. Under ERM1, we saw the use of such

controls during periods of crises. Nevertheless, the presumption is that the imposition of such controls would be exceptional and limited, and that their use would be governed by the rules laid down in the EU treaties.

It is important to realise that EU membership is not the same as EMU membership. It is true that for the current crop of accession candidates, any formal derogation from EMU membership, of the kind obtained earlier by the UK and Denmark, will no longer be possible. The obligation to join EMU, once the Maastricht criteria for membership are satisfied, will be part of the 'Acquis Communautaire' that candidate EU members will have to take on board.

However, whether or not, and when the Maastricht criteria are satisfied, will be to a significant extent at the discretion of the candidate member. Indeed, the Czech Republic is currently considering a modification of its central bank statutes which appears likely to violate the Maastricht Criteria. The Maastricht interest rate criterion will be quite difficult to satisfy for a number of accession candidates, because the market for 10-year government debt is thin or non-existent in quite a few of the accession countries. At the moment, the debt and deficit criteria do not seem to pose any serious problems, although a lot can change over a three to five year horizon.

In what follows I will focus on the inflation and exchange rate criteria for EMU membership. I will argue that, unless the exchange rate criterion is interpreted *asymmetrically*, that is, unless exchange rate appreciations are permitted during the two year 'probationary period' (unlike exchange rate depreciations), candidates for accession will be unlikely to satisfy both the exchange rate stability criterion and the inflation criterion.

Without such an 'exchange rate appreciation waiver' of the exchange rate stability criterion for EMU membership, membership of EMU is unlikely to be feasible or desirable for most accession countries for quite some time, even though early accession to the EU is a reasonable hope and expectation for quite a few of our countries of operations.

EU accession will have to be preceded by thorough institutional reform in the EU. The coming IGC will have to reform the cumbersome EU decision making procedures in a number of dimensions. The automatic 'one country, at least one Commissioner' rule, and its analogue on other decision-making EU bodies, will have to go. Qualified majority voting will have to replace the principle of unanimity for a wide range of issues. When that is achieved, and when the accession countries have satisfied the existing EU members that the 'Acquis Communautaire' has been properly incorporated in laws, directives, regulations and procedures, accession can, and will, take place.

The criteria for EMU membership will, however, be considerably harder to satisfy. I am not referring to the financial criteria, that is the ceilings on the general government deficit-GDP ratio of 3% and the ceiling on the gross general government debt-GDP ratio of 60%. These should not pose insurmountable obstacles. If Italy, Belgium and soon Greece can do it, so can most of the current candidates for early accession.

The problem lies in the combination of the exchange rate criterion and the inflation criterion. EMU candidates will (almost surely) have to join an ERM2 arrangement. Within the ± 15 percent bands, the exchange rate will have to be stable (without using capital or exchange controls etc.) for two years prior to joining EMU. The inflation rate cannot exceed the average of the three best performing countries by more than 1.5 percent, and

long-term interest rates are to be within 2 percent of the average in the three countries with the best inflation record.

Together, the exchange rate criterion and the inflation criterion severely restrict the scope for changes in the real exchange rate of the accession candidate vis-a-vis Euroland. To have a real appreciation, for instance, requires either a nominal appreciation (holding domestic and Euroland inflation rates constant), or a higher domestic rate of inflation relative to Euroland (holding the nominal exchange rate constant).

Real exchange rates of transition economies are volatile and subject to large medium-term swings. There can be little doubt, however, that for most accession countries, there must be the expectation, as part of the process of transition and catch-up, of a significant trend appreciation of the real exchange rate. The reason for this belief is the Balassa-Samuelson effect. Assume that the forces of international trade arbitrage equalise the inflation rates of traded goods and services (expressed in a common currency) between Euroland and the accession candidate. The inflation rate relevant for the inflation criterion for EMU membership is the inflation rate of a broad-based consumer price index, which includes both traded and non-traded goods. It seems likely that the differential between productivity growth in the traded goods sector and productivity growth in the non-traded goods sector is larger in the candidate accession country than in Euroland. This means that the relative price of non-traded goods to traded goods will be rising faster in the accession candidate than in Euroland. This in turn implies that, at a given exchange rate, the overall inflation rate will be higher in the accession candidate than in Euroland.

This could cause the accession candidate to fall foul of the inflation criterion. If it tightened policy and brought its inflation rate down to Euroland levels, the nominal exchange rate would be appreciating steadily, causing the country to fall foul of the exchange rate criterion.

Until the transition candidate has evolved, structurally, to the point that there no longer is any need for a steady appreciation of its real exchange rate, it will be very difficult, if not impossible, to meet both the inflation and the exchange rate criteria for EMU membership. The only way out of this dilemma is to interpret the exchange rate stability criterion asymmetrically, by permitting (possibly significant) nominal exchange rate appreciation during the two year period preceding EMU membership.

Without such an asymmetric interpretation of the exchange rate stability criterion, we are likely to see a possibly quite extended phase in which a number of the current accession candidates are in the EU but out of EMU. This is the position shared today by the UK, Denmark, Sweden and (until very recently) Greece. It is survivable but not comfortable. Following EU membership, the external trade of the successful accession countries will become more concentrated on the EU, and also on Euroland. Living with a floating exchange rate vis-a-vis one's main trading partners in a world with unrestricted mobility of financial capital is difficult.

The use of capital controls to increase the control over the exchange rate exercised by successful accession countries might suggest itself as a partial remedy. The problem is that capital controls become less effective, the longer they are in place. They also distort the international allocation of resources and limit opportunities for international risk sharing. They

encourage corruption and rent-seeking. They require a large and intrusive bureaucracy for their enforcement. On the positive side, they may make it more difficult to launder the gains from illegal activities, and may discourage tax evasion. Against that, they also criminalise perfectly reasonable actions aimed at minimising risk by diversifying one's portfolio.

Another technical way out of this box would be for the inflation criterion to be restated in terms of the inflation rate of some index of traded goods prices alone. That would require a change in the Treaty. I believe that either such a redefinition of the inflation measure or an asymmetric interpretation of the exchange rate stability criterion (permitting exchange rate appreciation) would be desirable. The benefits of EMU membership to successful EU accession countries are sufficiently important that some rethinking of the convergence criteria seems in order.

If a candidate accession country is successful in joining both the EU and EMU, it will also be necessary to permit its inflation rate following EMU membership to exceed that of the rest of the EMU area, by a margin warranted by the continuing need for real exchange rate appreciation associated with the continuing operation of the Belassa-Samuelson effect. This effect will cease to operate only when the new EMU member will have caught up with the productivity levels of rest of the EMU area. That will take decades rather than years.

Table 1
Exchange Rate Arrangements in 26 Transition Countries

(1) Albania	Managed float
(2) Armenia	Managed float
(3) Azerbaijan	Managed float
(4) Belarus:	Managed float
(5) Bosnia and Herzegovina	Currency board (euro)
(6) Bulgaria	Currency board (euro)
(7) Croatia	Managed float
(8) Czech Republic	Managed float
(9) Estonia	Currency board (euro)
(10) FYR Macedonia	fixed (de facto peg to euro)
(11) Georgia	Floating
(12) Hungary	Crawling peg with band; pre-announced peg to a currency basket (70% euro and
(13) Kazakhstan	Managed float
(14) Kyrgyzstan	Managed float
(15) Latvia	Fixed (informally) to the SDR
(16) Lithuania	Currency board (US\$).
(17) Moldova	Floating
(18) Poland:	Floating (used to be crawling peg with band; currency basket of US\$ and euro,
(19) Romania	Floating
(20) Russian Federation	Managed float.
(21) Slovak Republic	Floating
(22) Slovenia	Managed float
(23) Tajikistan	Managed float.
(24) Turkmenistan	Fixed vis-a-vis the dollar. There is an official rate and a parallel floating rate..
(25) Ukraine	Managed float
(26) Uzbekistan	Multiple exchange rate regime

Source: EBRD