

EXCHANGE RATE POLICY FOR EMERGING MARKET ECONOMIES

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Paper presented at the Academy of Business
And Administrative Sciences, Conference held at
the Budapest University of Economic Sciences,
Budapest, Hungary. July 13-15, 1998.

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I. Introduction

The particular exchange rate system suitable for a nation has been the subject of debate among economists for a long time. Many theoretical arguments have been put forward in support of the classic fixed exchange rate system and its suitability for various developing nations. Proponents of this system emphasize its simplicity, transparency, ease of operation, ability to impose discipline on domestic monetary policy and effective control over inflationary pressures. Opponents of fixed rates point out its inability to deal with fundamental structural changes in a developing economy. The lack of freedom to conduct independent monetary and fiscal policies in the context of emerging domestic as well as rapidly changing international markets is considered as one of its major drawbacks. While the lack of flexibility in the conduct of monetary policy dictated by the need to defend a fixed exchange rate is touted as a virtue by those who emphasize the need for inflation control, others decry the potential loss of competitiveness imposed by an unchanging nominal fixed exchange rate. With limited wage and price flexibility in domestic factor and product markets, a fixed exchange rate becomes progressively and rapidly misaligned over time. In consequence, overvaluation (loss of competitiveness) or undervaluation (declining terms of trade) of the exchange rate becomes a stifling burden that the economy finds it progressively harder to cope with. The real exchange rate, adjusting the nominal fixed rate for the inflation rate differential between domestic and world price indices, may appreciate or depreciate, distorting the flow of trade and payments. Though unobservable in practice, the real exchange rate does in fact exert a powerful influence on the direction and volume of international trade and capital flows.

Increasing disparity between the fixed nominal exchange rate and the underlying real exchange rate results in undesirable distortions at both the macro level (resource allocation) and the micro level (structure of incentives). Under these conditions, recurring balance of payments crises ensue, using up accumulated international reserves and depleting the ability of the central bank to continue to defend the exchange rate. Thus the credibility of the exchange rate regime is called into question. The appropriateness of the current par value, and oft-declared assurances of the monetary authority to adhere to it, become suspect. Eventually, the par value has to be adjusted, to stem the inevitable speculative capital outflows. Stop-gap measures such as restrictive trade policies, exchange controls and introduction of multiple exchange rates lead the country in the direction of greater insularity. Also, the need to raise domestic interest rates by a substantial margin to attract foreign short term capital, as well as to discourage the outflow of capital (to shore up the falling currency) may lead to recession, unemployment, and lower economic growth. The frequency with which the given parity is adjusted to reflect changing fundamental economic conditions may render the currency subject to recurring speculative attacks. Thus a fixed exchange rate, pegged to another dominant currency, may be devalued or revalued often, making it more or less flexible in practice. The de jure fixed rate becomes, in fact, a de facto flexible rate.

According to the International Monetary Fund's Annual Report on Exchange Rate Arrangements (1997), there are at least 9 different types of exchange rate regimes in operation. Some countries, such as Hong Kong, Argentina and Austria maintain a rigid peg with respect to another major currency, viz: the dollar or the deutschmark. There are many countries, both developed and developing, which have adjustable pegs tied to either a single currency (dollar, DM, franc, pound, yen) or a basket of currencies and/or the SDR. The range of adjustability differs from one system to another, but most of them provide for a minimum of +/- 2% (a narrow band) to a much wider +/- 20%. When the nominal rate hits either edge of the band, it triggers exchange rate intervention so as to keep the nominal value within the predetermined limits. While this arrangement economizes on foreign currency reserves of the regime compared to a fixed peg, it still requires a great deal of monetary and fiscal discipline to work reasonably well. Still greater latitude for the domestic currency to fluctuate is provided by systems that are variously known as Target Zones and Crawling Bands. Examples of countries that have adopted this regime include: Israel,

Columbia and Chile. In these systems, the *trigger for intervention* to move the currency back to its so-called central parity, keeps changing over time, rather than being kept at a constant and unchanged level. Then there are many types of managed floats, both published and unpublished, where the monetary authorities intervene either occasionally or continuously, to maintain reasonable stability in exchange rate movements, or to correct disorderly market fluctuations. India, Indonesia, Poland, Hungary and Turkey belong to this category. The degree of intervention may be occasional or much more frequent. Some developing countries also operate multiple currency systems, where various preferential and/or penal exchange rate arrangements exist for different categories of exports, imports, commercial loan transactions, debt service, travel and tourism expenditures and other private sector transactions. Some of the Latin American countries (especially Brazil, Venezuela and Mexico), have had such arrangements for many years. Finally, there are a few countries that have adopted pure floating rate regimes, but these are generally highly developed industrial economies such as USA, Japan and Canada. Thus many of today's exchange rate regimes have been operating with an array of permutations and combinations of apparent fixity with flexibility, as well as flexibility with fixity. Interestingly, countries in the European Common Market have, for some time, adhered to a modified version of the fixed exchange rate system in order to tie their currencies to each other more closely. With the impending introduction of the Euro in 1999, the Maastricht Treaty pulling together the nations of Western Europe into a single currency union, had laid down certain requirements that must be met by potential member nations before ushering in the common currency. The basic criteria or preconditions for launching the Euro and eligibility conditions for permanent membership of EMU for individual nations include:

- (i) No more than 2.5% inflation above the average EMU rate;
- (ii) Government deficit as a percentage of GDP below 3%;
- (iii) Government debt as a percentage of GDP below 60%;

- (iv) Exchange rate fluctuations to be limited to no more than 2.25% of central parity (essentially choosing the DM as the central anchor currency)
- (v) National interest rates to stay within 2% of the average EMU rate.

Surprisingly, countries such as Italy and Portugal, which were not originally expected to meet all the requisite criteria because of their large annual budget deficits, weak inflation track records and huge public debt burden, have shown great willingness and determination to meet these rather stringent eligibility criteria. Others, such as Ireland and Greece, because of their inability to meet inflation and deficit goals before 1999, have opted to wait awhile before preparing for full participation in the EMU. This is salutary for the Euro, and augurs well for its successful introduction in 1999.

This brief discussion of current exchange rate regimes naturally raises a valid and fundamental question about which type of system is most suitable for a DEVELOPING ECONOMY. In order to attempt an answer, we now look at some of the economic/financial characteristics of EMERGING MARKET ECONOMIES. This issue is explored in Section II. Some of the basic criteria which must be addressed in deciding on the appropriate exchange rate regime for *Emerging Markets* is taken up in Section III. Finally, Section IV concludes with a brief assessment of the benefits and costs of choosing a particular regime.

II. Emerging Markets

There are many ways in which the term *emerging markets* can be understood. One simple definition, used by the World Bank, is that countries with per capita GDP of \$1,265 in 1995, and which have instituted various fiscal, financial and trade policy initiatives to bring about greater integration of their economies into the global market place, belong to this category. In these countries, fundamental structural reforms needed to bring about greater freedom for goods and factors of production to move internationally, have meant changes such as:

- (a) Opening up of hitherto protected or prohibited capital markets to private investors.
- (b) Privatizing and/or sale of many loss-ridden government enterprises, or public sector businesses, so as to improve their efficiencies through application of principles governing adequate rates of return on investment.
- (c) Liberalizing antiquated and burdensome banking, financial, securities and fiduciary regulations to streamline the operation of the financial infrastructure.
- (d) Getting rid of an array of taxes, subsidies, foreign trade controls and other regulations originally designed to discourage/modify market-determined resource allocation.
- (e) Fundamental reform of the prevalent chaotic tax systems so as to get rid of many disincentives, and substantially reduce the extremely high marginal tax rates which stifled initiative and enterprise, and led to frequent tax evasion and corruption.
- (f) Simplification and/or elimination of administrative arrangements that controlled and directed resource allocation through non-market channels such as licenses, permits, national-origin requirements, quotas and other types of government intervention.
- (g) Greater freedom for participation by foreign investment in local equity and bond markets, as well as opportunities for domestic capital to invest abroad.
- (h) Simplifying rules for foreign direct investment in collaboration with private national firms, and liberalizing rules for repatriation of capital and/or profits. Generally speaking, all such reforms manifest an increased appreciation for, and a greater willingness to let the power of the market mechanism determine the allocation of resources--labor, capital and enterprise--so that prices reflect the revealed preferences of the public.

The central goal of these reforms is to simplify and modify cumbersome rules and regulations, so that market transactions and the associated incentive system become more transparent. It bears repeating that these principles are designed to encourage greater private risk taking, reduce or minimize the existing tax burden, improve the credibility of the fiscal/financial apparatus, encourage the inflow of foreign capital and technology, and finally, to bring closer together the investor's perceptions about the risks and rewards of entrepreneurial activity.

Characteristically, most nations which are currently labeled as *emerging markets* have adopted, or are in the process of bringing about, reforms designed to encourage greater international trade and investment. As a result, they typically experience an array of growing pains, which they must endure for a while. For example, elimination of subsidies and removal of erstwhile administrative arrangements for allocating resources, bring about greater open inflation. Freeing markets from the shackles of bureaucratic controls, increases unemployment temporarily. Removing restrictions on imports and liberalizing rules for domestic capital to go abroad, results in excess demand for foreign currency and an associated change in the exchange rate. Monetary and fiscal policies needed to institute the country's new market orientation, result in increased conflict among

different policy objectives. Thus, while the long term benefits of economic reforms increase the economy's productive potential, step up its rate of growth of GDP, and improve its factor productivity/efficiency, all Emerging Markets go through a transitional period of increased vulnerability to change. Some notable examples of such countries in the process of economic transition are:

Latin America: Argentina, Brazil, Columbia, Mexico.

Europe: Ireland, Portugal, Greece, Turkey, Czech Republic, Poland, Hungary

Africa: South Africa, Zimbabwe

Middle and Near East: Israel, India, Pakistan

East Asia: South Korea, Philippines, Hong Kong, Indonesia, Thailand, Malaysia, Taiwan.

What type of exchange rate policy will help these nations during the transition period? How can it be implemented? What are the advantages and disadvantages of adopting a particular exchange rate regime? Will it promote objectives such as:

1. Reasonable exchange rate stability.
2. Greater volume and variety of exports to finance increased import requirements needed by a growing economy.
3. Improve competitiveness vis-a-vis other countries in world markets.
4. Greater efficacy in inflation control.
5. Minimize destabilizing speculative attacks on the currency, by improving credibility of the regime, and making transparent exchange intervention initiatives when called for.
6. Maintenance of the desired level of capital flows and the need to attract external investment resources for economic growth.

These are some of the important considerations in the selection of an appropriate exchange rate regime. We now turn to a discussion of these issues.

III. Choosing an Appropriate Exchange Rate Regime Policies of individual countries must be geared to their national priorities and overall macroeconomic objectives. It should reflect their resource endowments, actual and potential comparative advantage, and ability to take advantage of rapidly shifting demand and supply conditions. Countries which are primary producers or natural resource-intensive exporters may face inelastic demand for their products (eg. commodity exports like coffee, copper, oil, rubber, tin, spices, lumber, etc). Several developing countries trying to diversify their export base into newly manufactured products do face stiff competition in export markets from other developing countries, as well as the import-competing sectors in developed countries. Export earnings could be stagnant or be subject to recessionary conditions in importing countries. While some emerging market economies are able to diversify their structure of production and trade and take advantage of expanding world markets, others find that their resources are either immobile, or are unable to adapt to the ever-changing patterns of external demand.

Yet, many have found innovative and imaginative ways of generating new export revenue. They have been successful in adapting to the extremely competitive and evolving international market for new goods, services and ideas. For example, countries such as Costa Rica, Zimbabwe and New Zealand have been able to capture the growing boom in international travel and tourism. They have consciously followed a policy of developing their ecological assets to attract tourists from many countries, generating new and previously untapped methods of raising foreign exchange. Greater investments in improving

and preserving their pristine forests, flora and fauna and many natural wonders have enabled them to generate high rates of growth in tourism revenue.

Many East Asian countries (notably South Korea, Taiwan, Malaysia and Indonesia) have emphasized manufacturing for export markets, and have successfully diversified their economies away from traditional, natural-resource intensive products. Exports of newly manufactured goods such as electronics, telecommunication equipment, computers, automobiles and related parts from these *newly industrialized countries--NECs* have been the envy of other Emerging Market nations. Likewise, Singapore and Hong Kong have been able to develop as South East Asia's regional centers for providing various financial and investment products. They have capitalized on their reputation as Asia's preeminent international financial centers to market a broad array of financial services. In competing intensely with Tokyo, London and New York, they have not only held their share, but vigorously expanded in newer markets everywhere.

Many of Europe's Emerging Market nations (eg. Ireland, Spain, Portugal, Austria, Poland, Czech Republic and Hungary) are able to generate ever increasing volume of export income by bidding as sub-contractors for different types of processing activities (including financial transactions) needed by firms in OECD countries. Their disciplined, educated and highly motivated/skilled (yet relatively cheaper) human capital assets are proving to be a distinct advantage in producing and servicing many of today's high tech products. Many new manufacturing and assembling activities by multinational companies to meet the needs of growth markets throughout Europe, are being set up in these economies. Thus it is clear that Emerging Market economies need to take advantage of their dynamic comparative advantage in creating and exploiting opportunities for export growth in traditional as well as new external markets.

It is imperative that the exchange rate regime which can support and sustain the evolving rapid transformation in international trade and payments in Emerging Markets should be robust, flexible and credible. It should be capable of handling large and frequent fluctuations in currency movements. It should provide for adequate financing of temporary imbalances in the overall balance of payments. Above all, it should reflect the country's evolving need for foreign capital. One of the distinguishing characteristics of capital movements in the 1990s has been the increasing need for portfolio diversification by large institutional investors such as pension funds, mutual funds and other international asset holders. External capital inflows of all types (such as: foreign direct investment; equity participation by foreign investors; portfolio movements across different industries and countries sought by specialized mutual funds; formation and expansion of closed-end country investment funds; public bond financing; borrowing needs of domestic firms which have access to world capital markets, as well as short term capital movements seeking high rates of return), would certainly continue to play a vital role in these nation's external balances. Large, unexpected and volatile inward and outward flow of funds, both temporary and permanent, will challenge the stability and liquidity of their external payments mechanism. Occasions frequently arise where the domestic currency will tend to appreciate and depreciate intermittently (by large margins) in quick succession. In addition, investors' perceptions about the impact of the country's domestic fiscal and monetary policies will be reflected in rapid and volatile movements of the exchange rate.

Under these conditions, the need to adhere to long-term, responsible and growth-inducing macroeconomic policies while controlling inflationary pressures, become obvious. The exchange rate regime should simultaneously provide incentives for the growing array of competitive export products (and services), and also make provision for the orderly inflow of bursts of foreign capital, without jeopardizing the country's other macroeconomic goals. 'Hot money' or volatile short-term capital movements should not be allowed to wreck other vital national economic objectives.

In this economic climate, the best compromise between providing for adequate competitiveness of exports as well as full employment and economic growth, and minimizing the costs of sudden and unexpected (but probably short-lived) changes in the external value of the currency, seems to be a Crawling Band with wide margins. The *crawl* allows for macroeconomic fundamentals such as planned fiscal deficits (or surpluses), rates of projected monetary growth, productivity changes, gaps between domestic saving and investment rates and long-run inflationary or deflationary pressures. It allows ample

freedom for the exchange rate to move upward or downward in response to these and other semi-permanent national policy initiatives. At the same time, the moving exchange rate reflects the changing relationship between the purchasing power of the domestic currency and currencies of both the importing countries and other potential competing exporters. This is provided for automatically by the *crawl*, eschewing the need for ad hoc or periodic adjustments. Thus the exchange rate remains reasonably competitive under varying economic conditions. It responds to sudden bursts of capital movements in an appropriate way, by either depreciating (capital outflows) or appreciating (capital inflows) temporarily. By choosing a wide band from say, +/- 5% to as much as +/- 20%, depending on how much variability in the rate is considered desirable, the authorities can minimize the

need for intervention when the current rate fluctuates, but nevertheless remains within the predetermined band. The appropriately chosen band width obviates the need for frequent intervention, except when the rate continuously hovers around one of the edges of the band. Thus foreign exchange reserves can be conserved, and the cost of sterilized intervention resulting from unanticipated capital inflows can be managed economically. Market perceptions about the country's exchange rate policy becomes transparent, and chances of speculative attacks on the currency are minimized. By providing resilience as well as a credible commitment to maintain currency movements within the preannounced margins, one-way speculation about the level of the exchange rate becomes unprofitable. The tendency for the rate to appreciate occasionally consequent on sudden, large inflows of foreign capital is counterbalanced by the opposite tendency for it to depreciate when outflows of hot money put downward pressure on the system. And the authorities retain the option to nudge the rate towards the desired direction, without their intentions being misunderstood or misinterpreted by the market. The need for long term capital imports to finance economic development or the recurring current account deficit is satisfied. Most foreign institutional investors in Emerging Market securities prefer dollar or DM denominated (or exchange rate guaranteed in terms of a key foreign currency) financial assets. By judiciously picking the band width, their preference for limited exposure to exchange rate risks can be met more easily. Policies designed to welcome stable inflows of long term foreign capital, while taxing or regulating disruptive short term movement of funds, can be useful in mitigating unwanted exchange rate changes. Some Latin American countries, notably Chile and Columbia have successfully adopted this strategy.

V. Concluding Comments

One of the interesting features of the *crawling band* is its ability to limit excessive movements in currency values. By confining exchange rate fluctuations within the desired margins, the adverse consequences of excessive resource movements between tradable and non-tradable industries can be avoided. At the same time, some gentle guidance can be given to export and import competing industries to take advantage of changing market conditions. The experience of Israel, Chile and Columbia in administering their crawling bands for almost a decade, and achieve reasonable success in stable exchange rate management, should be of interest to other Emerging Market nations. Much of the excessive fluctuations in exchange rate values in these countries witnessed in 1997-98, could perhaps have been prevented by adopting such a system. It provides a viable and reasonable compromise between overvaluation and under-valuation resulting from excessive rigidity of many pegged rate systems. In a world beset with increasing capital mobility and open markets, it allows for adequate protection against wild and undesirable fluctuations in exchange rates. Its proven effectiveness in providing competitiveness by stimulating exports and limiting gyrations in the exchange rate should recommend it to policy makers in many Emerging Market economies.

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