Exchange Rate Regimes in Emerging Economies

by

SEBASTIAN EDWARDS

University of California, Los Angeles

and

National Bureau of Economic Research

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Six Assertions

- The “middle ground,” in terms of exchange rate regimes, is ***dead***
- There are “good fixes” and “bad fixes”; there are “good flexes” and “bad flexes”
- “Dollarization” makes sense for some countries, but not for all
- A “common currency area” for the Americas is unlikely to happen any time soon
- Some countries should Dollarize unilaterally
- For most (but not all) countries, a “good flex” maybe easier to achieve than a “good fix”

Good and Bad Fixes

- A "good fix":
  - Solves credibility problems
  - "Forces" policy makers and politicians to act in a fiscally responsible fashion
  - Results in macroeconomic stability
  - Coexists with a flexible economic structure; thus, shocks are accommodated without "excessive" unemployment
  - Solves the "lender of last resort" problem in and efficient way
- A "bad fix" does not achieve any of the above
  - In general, credibility problems are pervasive and costly

Good and Bad Flexes

- Under a "good flex":
  - The nominal exchange rate is the main (but not the only) shock absorber
  - The Central Bank abstains, under most circumstances, from selling or buying international reserves
  - There is an increased monetary policy independence
  - Coexists with fiscal austerity, and results in low inflation
  - Coexists with strong banks
- A "bad flex" does not achieve any of the above
  - It is a peg in disguise

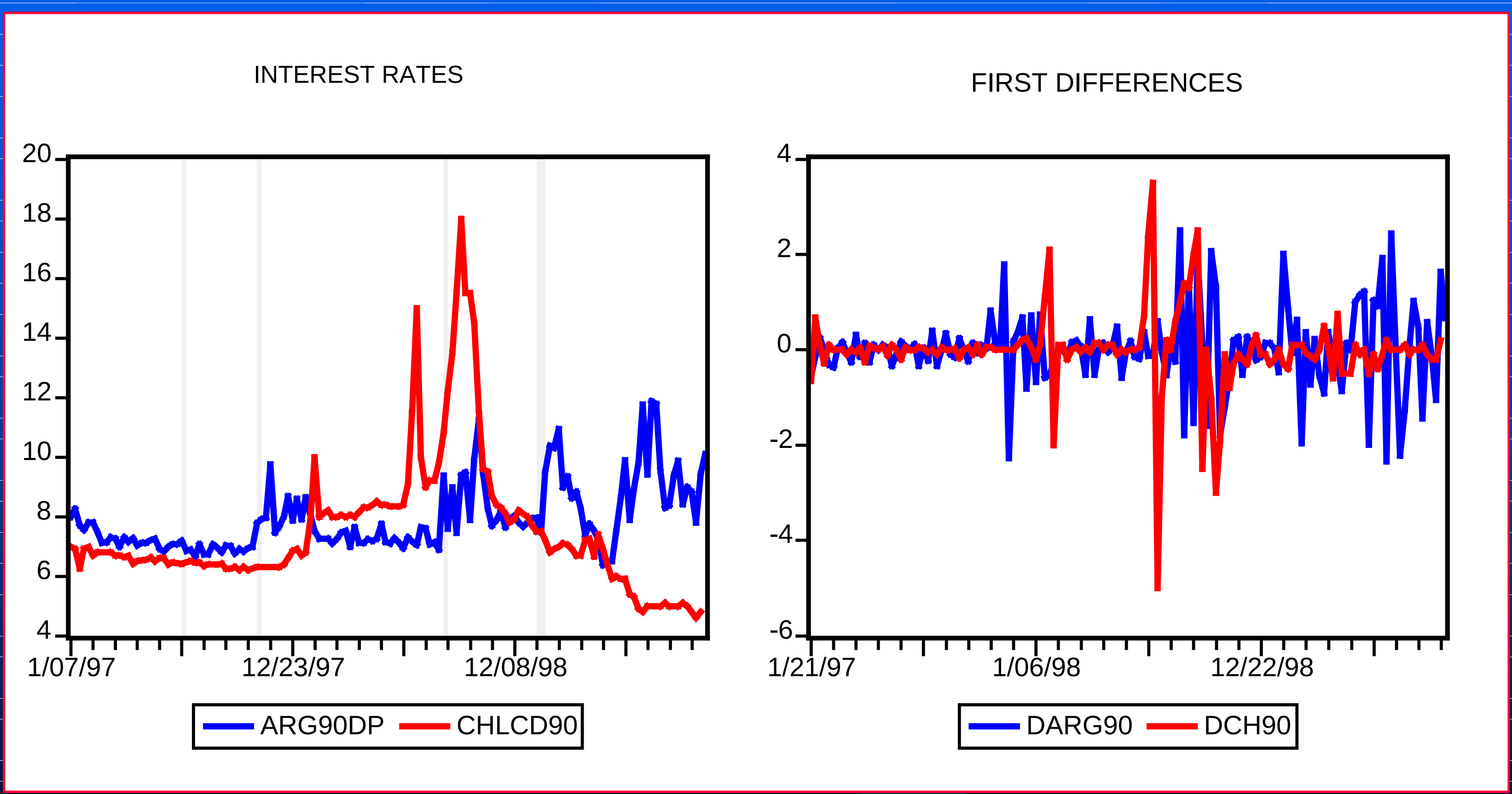
Latin American blues:

- We don’t have “good fixes”, yet...
  - Argentina is not a good fix
  - Neither is Panama
- We don’t have “good flexes”, yet…
  - Mexico has not been a very good flex
- In Latin America, fixes and flexes have been affected by two historical problems:
  - Pro cyclical capital flows
  - Pro cyclical fiscal policy

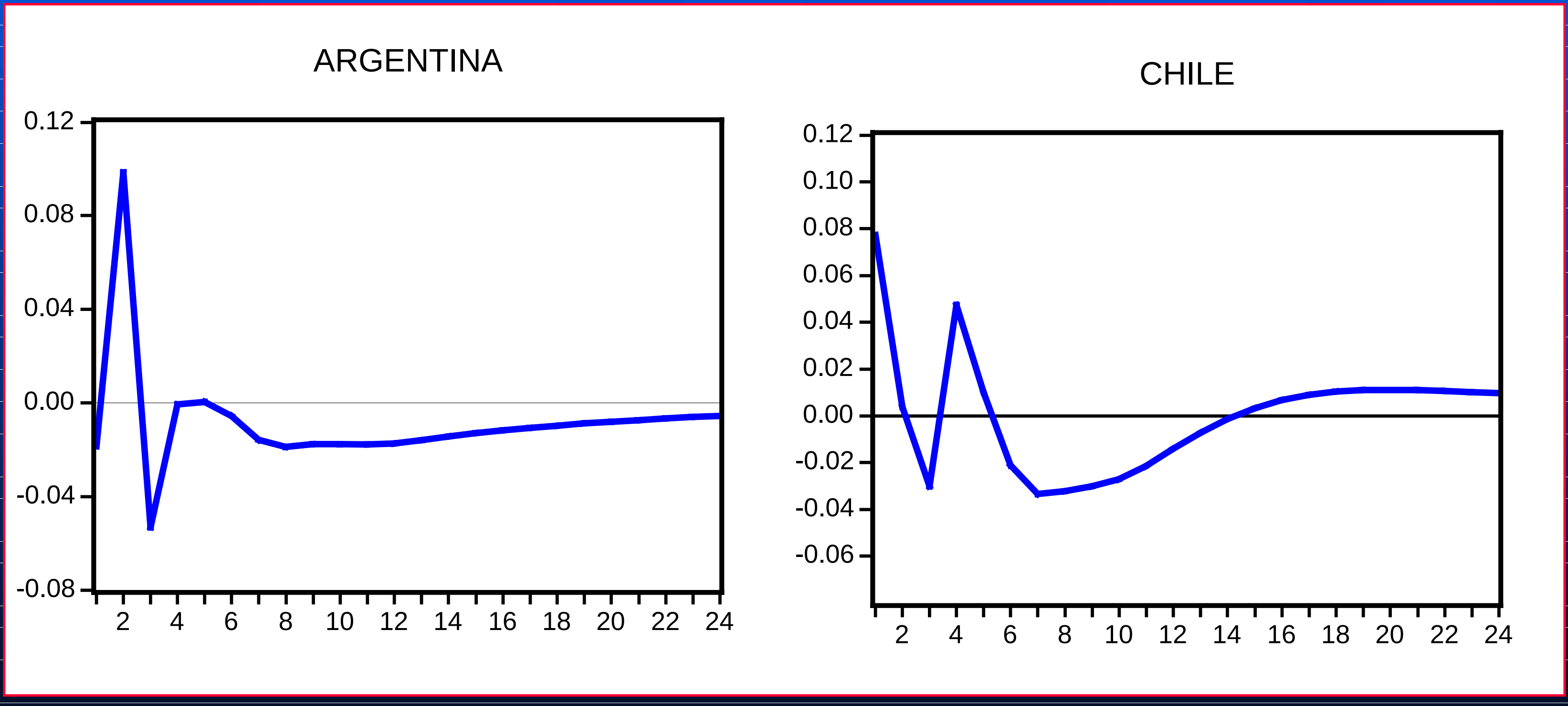
How Stable has Argentina Really Been?

- It has been compared with Mexico
- But Mexico has been affected by major crisis; may not be the right comparison
- Chile is another possible benchmark for comparison

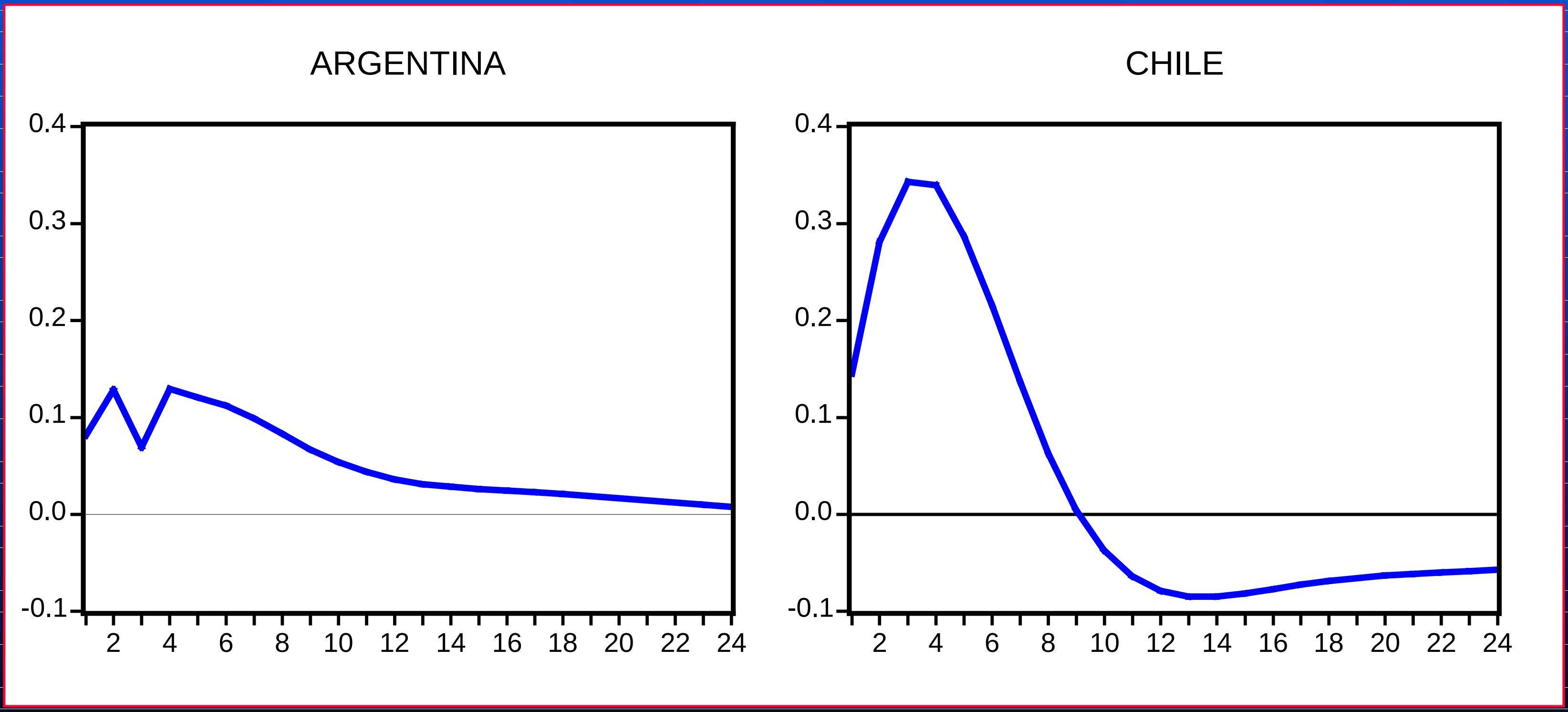
Crises and Domestic Interest Rates: Argentina and Chile



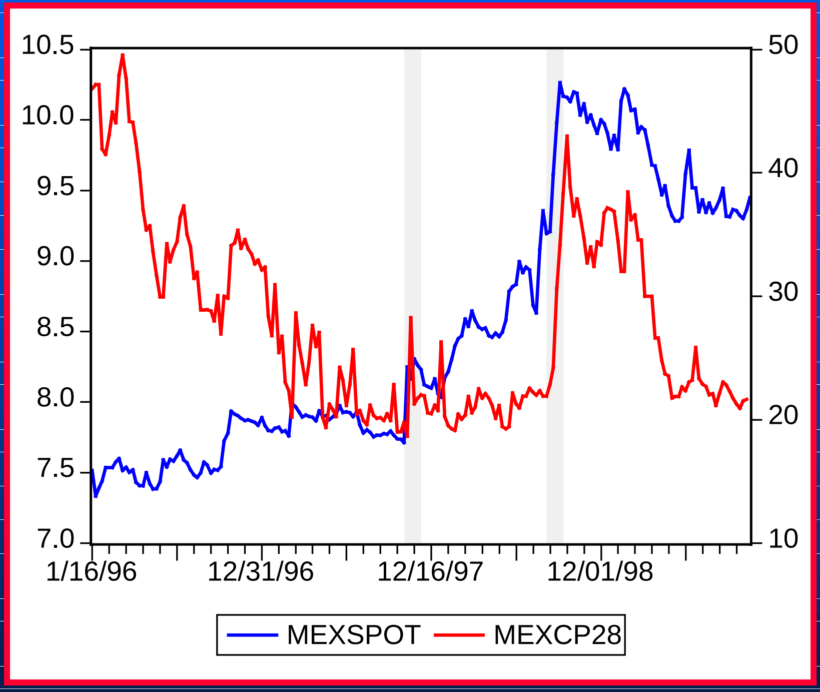
Interest Rate Response to a Shock to Latin American Risk: Argentina and Chile



Interest Rate Response to a Shock to Non-Latin American Risk: Argentina and Chile



Exchange Rate and Interest Rates: Three Phases in Mexico's History



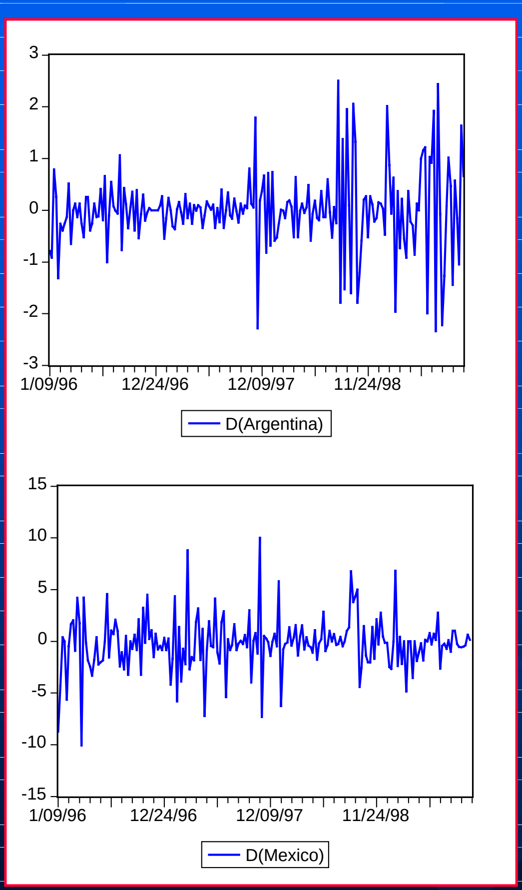
- Correlation coefficient

A. 96/1 - 97/10 ***-0.63***

B. 96/11 - 98/7 ***0.06***

C. 98/8 - 99/10 ***0.77***

Interest Rate Volatility in Argentina and Mexico



How to Accommodate Changes in Equilibrium Real Exchange Rates ?