Searching for the Right Currency Regime for Emerging Economies

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There is no such a thing as an optimal currency regime for emerging economies. As with most political and economic institutions, the best rules of the game depend on very country specific historical circumstances. The best that theory can do to help institution building in emerging economies is to point out the risks associated with the acknowledged distortions in each type of second-best solution.

However, to open the door to the best solution for emerging economies, a future International Monetary System should offer them the opportunity of becoming full members of a monetary union that will meet the conditions identified by Nobel Prize laureate Robert Mundell for optimum monetary areas.

Monetary Union is Best

Nowadays, countries which are eligible to become members of the European Union enjoy the prospect of joining the euro. But this is not the case for emerging economies that do most of their foreign trade with the US or Japan, because neither of these two leading nations have demonstrated any intention of having their national currency regimes evolve into larger Monetary Unions. In an ideal world, a good way to move in the direction of building a better International Monetary System that would increase the prospects of stability and growth for the global economy, would be to have the US and Japan demonstrate a willingness to use their currencies as the base for enlarged monetary unions that would offer to their developing country commercial partners the possibility of adopting the best possible currency regime. But so far, there are no signals that the US and Japan like this idea.

A currency regime is an essential part of the institutional base of an economy. If an emerging economy is unable to create a good currency regime, it will lack the financial and capital markets that are essential for the financing of productive investment. With those limitations it will be difficult for such an economy to simultaneously achieve stability and growth.

A good currency regime has to provide at least one currency to efficiently fulfill the following roles: a means of exchange for every kind of market transaction (spot, future, domestic, foreign) and a store of value. No doubt the best currency regime for a national

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economy is that of the US today or that of the UK at the time of the British Empire. One currency, the Dollar today or Sterling prior to WWI, is accepted worldwide for every kind of transaction and is considered a secure store of value. Nowadays, only Europe, as a Monetary Union and eventually Japan if it finally decided to internationalize the Yen, are in a position to create such a currency regime. In the three cases, the currency permits the existence of spot and future markets of every imaginable kind, while long term interest rates are close to some concept of a ”natural rate,” reflecting long term expectations of price stability.

The Second Best Option

The second best currency regime for emerging economies would involve the use of a domestic currency different from those used in foreign transactions, or simply adopting the Dollar, the Euro or the Yen for domestic transactions. Countries will find significant advantages in using one of the three foreign currencies for domestic transactions if two conditions apply: they have large amounts of trade with one of the three monetary areas and a long history of inflation in the past has prevented the creation of future markets and long term financial contracts. Foreign currencies will clean the national economy of inflationary expectations and will allow the immediate creation of future markets that could not exist in an inflationary environment.

This means that the long term interest rate will be much lower that otherwise. The difficulty that these emerging economies may face relates to the inexistence of a central bank that may act as lender of last resort. But this may not be relevant because even with a domestic currency, if it is not credible enough, the chances of the central bank providing lending of last resort will be very limited. At times of financial crisis, there is demand only for the foreign currency, while increased supply of the domestic one will only feed hyperinflation. This explains why Panama, Ecuador and El Salvador have already adopted the Dollar as their currency, and why most of the economies in Central America and the Caribbean will very likely in the future pursue the same course.

When the second best currency regime includes a domestic currency, the economy involved has to define two main features for it: the degree of convertibility between the domestic and the foreign currency, and the degree of flexibility of the rate of exchange. If past experience allows that particular emerging economy to have a currency regime that combines the maximum of convertibility with the maximum of exchange rate flexibility, then there is no doubt that economy should choose full convertibility and a free float for the national currency. The UK, Switzerland, Canada, Australia, New Zealand, Singapore and a few other economies chose that path long ago.

Convertibility vs. Flexibility

The typical dilemma for an emerging economy that has had a long experience of persistent inflation, and even worse, hyperinflation, is how to deal with the trade off

between convertibility of the domestic currency and flexibility of the exchange rate. The degree of convertibility needs to be somewhat restricted so that the Central Bank has some capacity to conduct an independent monetary policy through the flexibility of the exchange rate. Otherwise everybody would use the foreign currency for most domestic transactions, particularly those involving long term contracts. The typical restriction to convertibility that is commonly imposed involves prohibiting financial institutions from accepting foreign currency deposits from residents and prohibiting them from lending domestically in the foreign currency. As this limitation to convertibility may generate the flight of domestic savings in economies that have long been exposed to periods of inflation, it is normally accompanied by some additional restrictions on the transfer abroad of residents' funds.

These restrictions may impose significant distortions on the economy, particularly if residents interpret them as the government leaving the door open for the imposition of a future capital levy through sudden devaluation and inflation. These distortions will be reflected in high long term interest rates or simply the inexistence of long term savings and financing. That is why some emerging economies may prefer, at least for a while, to sacrifice exchange rate flexibility but to grant full convertibility to their domestic currency by managing it through a currency board. This was the case of most economies in the world between 1870 and 1930, at the time of the Gold Standard, as well as Malaysia and Singapore immediately after independence, Argentina from1991 until the end of 2001, and Hong Kong from 1983 to the present.

The challenge is to minimize the risk that the sacrifice of exchange rate flexibility in favor of full convertibility will end up in the catastrophic way that it did for countries participating in the Gold Standard in the thirties and for Argentina in 2002. The emerging economies that choose full convertibility should exit the fixed exchange rate as soon as a persistent inflow of foreign capital calls for an appreciation of the domestic currency. That should be taken as an indicator that the economy is ready to combine full convertibility of the currency with free floating of the exchange rate. This is what Singapore did in the early nineteen seventies.

Other Alternatives

Emerging economies that have had a history of inflation but consider it too risky to sacrifice exchange rate flexibility, particularly those that are prone to suffer severe external shocks, will probably try other institutional tools rather than full convertibility, in order to lower long term interest rates and encourage medium and long term savings and financing. Chile, and to some extent Brazil and Mexico, have successfully used financial indexation as an alternative to full convertibility. But whatever the mechanism used to remove the distortions created by lack of full convertibility, crises will be unavoidable if there is not enough fiscal discipline in emerging economies which have a long history of inflation.