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Summing Up by the Acting Chairman
Exchange Rate Regimes in an Increasingly Integrated World Economy
Executive Board Meeting 99/107
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Executive Directors welcomed the opportunity to revisit the question of choice of exchange rate regime—a topic central to the Fund's mandate and to the international monetary system. They considered that the diversity of exchange rate regimes present in the international monetary system was likely to continue, and emphasized that no single exchange rate arrangement was appropriate for all countries, or in all circumstances. Many factors properly enter into the choice of regime. These primarily include economic criteria, such as the extent of trade with partner countries, symmetry of shocks, and the existence of institutions and markets able to handle exchange rate fluctuations. But they may also include political considerations, such as a desire to proceed with regional integration.

Many Directors considered that the widespread liberalization and expansion of capital movements had made it more difficult to sustain pegged rates and thus, for a significant number of countries, had tended to shift the balance of advantage in favor of adopting more flexible regimes. However, Directors emphasized that exchange rate flexibility was not a soft option and that exchange rate and macroeconomic stability required the pursuit of stability-oriented policies. They also acknowledged that very constraining pegs—such as currency boards—when supported by macroeconomic policy discipline, could also be credible and sustainable.

Directors agreed that, whether exchange rates were pegged or flexible, greater capital mobility had exposed domestic financial institutions to increased pressures in the form of interest rate or exchange rate fluctuations, which underlined the essential need to strengthen financial systems. Directors also emphasized the contribution that other factors—such as corporate financial structures and transparency in public decision-making—could make to the effective operation of exchange rate regimes, both pegged and flexible. They also pointed to the need to encourage the development of futures and forward markets that would make it easier to hedge against exchange rate movements.

Directors considered the regime likely to prevail in the medium term among the three major currency blocs centered on the dollar, the euro, and the yen. These currencies would likely continue to anchor the international monetary system, and thus affect significantly the environment in which other countries' exchange rate choices are made. The launch of the euro at the beginning of 1999 was a major event for the international monetary system. Directors did not believe that it would change the existing system of flexibility among the exchange rates of the key currencies, nor did most Directors consider that there was any evidence that the euro would fluctuate significantly less against the dollar and the yen than had been the case for a basket of its component currencies. Directors considered it likely, as well as appropriate, that the largest countries would focus their monetary policies primarily on domestic considerations, especially to ensure domestic price stability, rather than target a particular level for their currency's exchange rate. While recognizing the constraints on the effectiveness of remedial official action, Directors nonetheless emphasized that large misalignments and volatility in these currencies' values were a cause for concern, in particular for small, open commodity-exporting countries. They stressed that the Fund should remain vigilant and ensure that externalities arising from the macroeconomic and structural policies of major currency countries are fully taken into account in the surveillance process. A few Directors pointed to the potential benefits of coördinated exchange rate management to further help limit short-term exchange rate volatility.

For the smaller more open economies, and especially those with limited involvement in global capital markets, Directors considered that a peg to one or another of the major currencies, or to the currency of a dominant trading partner (where one existed), or to a basket of currencies would likely continue to be the preferred course. For such countries with both disciplined fiscal policies and no reason to exercise an independent monetary policy, a peg could be credible and hence unlikely to suffer from speculative attacks.

For a significant number of other economies, however—notably medium-sized industrial and emerging market economies—many Directors considered that the heightened policy requirements imposed by the liberalization of capital flows had increased the difficulty of defending pegged rates. As a result, they perceived a tendency toward either more flexible arrangements or more constraining, and hence more credible, exchange rate systems—including the adoption of a currency board, "dollarization," or monetary union involving a move to a common currency. Directors noted that this tendency had been evident among industrial countries. A number of medium-sized countries have flexible exchange rates, while others, particularly in Europe, have replaced national currencies with the euro. Directors observed that this tendency had been less evident among developing countries, in part because for many of them capital mobility is still restricted.

Most Directors agreed that for many of the so-called "emerging market economies," which by definition have access to international capital markets, a substantial degree of exchange rate flexibility is desirable. However, they did not consider that freely flexible exchange rates would be a viable option for all such economies, and recognized that in practice, many would want to use intervention and domestic monetary policy to guide exchange rate movements. Such arrangements could be loosely managed or they could be less flexible, including a crawling peg or band. Directors also noted that pegged rates (or active crawling pegs) could be quite appropriate in other circumstances, such as stabilization from high inflation.

Directors noted that under a flexible regime, a credible alternative framework to the exchange rate peg is needed to provide a nominal anchor. A number of Directors believed that inflation targeting could provide such a transparent and credible framework for developing countries, just as it does for several industrial countries. Some Directors stressed that the preconditions for successful inflation targeting, which included the independence of the central bank from fiscal or political pressures, a reliable framework for forecasting inflation, and the ability to move interest rates to attain the inflation objectives, were not satisfied in many developing countries. In the view of these Directors, these considerations might reinforce the case for countries adopting a pegged arrangement.

In considering whether regional exchange rate arrangements might be appropriate for groups of developing countries, Directors focused on two regions, Mercosur and ASEAN. Some Directors considered that in neither of these cases did the countries in the region form an optimum currency area, since some of them had different economic structures and faced different shocks. They stressed that not only economic similarity, but also political solidarity, was necessary to make a monetary union work. On this criterion, both Mercosur and ASEAN probably needed to progress further in their commitment to regional institutions before contemplating monetary union. Other Directors pointed out that the ongoing macroeconomic stabilization and structural reforms in countries in these areas should help achieve faster progress toward regional groupings.

Directors also considered the issue of exchange rate policy advice in the context of Fund-supported programs, noting that past practice has been not to dictate the member's exchange rate arrangement, but rather to assess the consistency of economic policies with the regime chosen. Directors noted that in recent programs with Asian crisis countries and with Mexico, large-scale Fund assistance had been provided after an exit from unsustainable official or de facto pegs or bands, rather than in defense of an exchange rate commitment. Nevertheless, the Fund had at times provided financing to countries with pegged exchange rates that were forced to abandon them during the life of the program, two recent examples being Brazil and Russia.

Directors recognized that countries' choices regarding exchange rate regimes could be difficult and sensitive. While taking due account of these difficulties, the Fund should offer its own views to assist national authorities in their policy deliberations. In particular, the Fund should seek to ensure that countries' policies and circumstances are consistent with their choice of exchange rate regime. In some cases where the issue arose, this would require the Fund to offer advice on an appropriate strategy for exiting a fixed exchange rate regime. Directors agreed that the Fund should not provide large-scale assistance to countries intervening heavily to support an exchange rate peg, if this peg is inconsistent with the underlying policies. In this context, some Directors stressed the importance of supporting institutional arrangements that can help make domestic policy commitments more credible.

In closing the discussion, Directors agreed that there were no simple answers to the question of the choice of exchange rate regime. Depending on a country's starting point in terms of inflation history, economic structure, and political commitment, various arrangements ranging from a hard peg to a high degree of exchange rate flexibility could be considered. Whatever exchange rate regime was adopted, however, its consistency with underlying macroeconomic policies was essential. Directors further noted that the Fund should continue to exercise firm surveillance over the exchange rate systems of members and should strive to provide clear advice to members on their choice of exchange rate systems. Directors agreed that the Board needed periodically to revisit country experience and the Fund's policy advice in this important area, which was central to its mandate.