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Which exchange rate regimes in an era of high capital mobility?☆

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Abstract

This paper asks what influence increasing capital mobility has on the choice of exchange rate regime. Among exchange rate regimes considered are currency boards and dollarization. It is argued that a key lesson of the recent currency and financial crises in the emerging markets is that corner solutions in exchange rate policy may be preferable to less rigidly fixed exchange rates. The paper concludes that in the end the optimal exchange rate regime depends on the circumstances of a particular country and time, because each exchange rate system requires the fulfillment of certain preconditions. The paper then discusses institutional measures and innovations that may be necessary to enable exchange rate arrangements to avoid financial and currency crises or to dampen their consequences. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

The 1990s witnessed a tremendous increase in capital mobility and financial globalization. They also saw serious financial and currency crises. It is now widely believed that a global move toward greater exchange rate flexibility, on the one hand, or toward fixed exchange rates, on the other, would have avoided many of the problems that the international financial

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system has suffered in recent years. Pure floating and monetary union are the two regimes that cannot by construction be subjected to speculative attack.

However, we know that free floating includes a tendency toward volatility. This exchange rate volatility is not always based on macroeconomic fundamentals and includes occasional speculative bubbles and crashes. This volatility could be avoided by adopting a monetary union. However, we know also that a worldwide monetary union is not implementable for a variety of reasons. Thus, one is forced to fall back on second-best solutions such as regional monetary unions, currency boards and dollarization.

In the next section, I shall briefly discuss the conceptions of currency boards and dollarization. In the subsequent section, I shall deal with the causes of recent financial and currency crises, particularly in Asia, to determine whether corner solutions in exchange rate arrangements are suitable remedies for these types of financial and currency crisis. In the last section, I shall discuss further institutional measures or innovations which appear to be necessary as a supplement or a substitute to corner solutions in exchange rate arrangements in order to avoid financial and currency crises or to dampen their consequences.

2. Currency board and dollarization

2.1. Currency board

There is a growing consensus that countries can enjoy the benefits of fixed exchange rates only by either maintaining extensive capital controls, or by adopting a credible commitment to fixity.¹ Countries which want to avoid the costs of both currency flexibility and capital controls, and therefore seek credibility for their fixed exchange rate, may wish to consider a currency board.

A currency board is a monetary institution that fixes a country's exchange rate and permits high-powered money to be created only if it is fully backed by holdings of foreign exchange. It is characterized by

- an exchange rate that is fixed not just by policy, but by law;
- a reserve requirement ensuring that each dollar's worth of domestic currency is backed by a dollar's worth of foreign reserves; and
- a self-correcting balance-of-payments mechanism, in which a payments deficit automatically reduces the money supply and results in a shrinkage of spending.

The use of currency boards (mainly in British colonies) peaked in the 1940s and declined thereafter. In recent years, there was a resurgence in their use when arrangements similar to currency boards were introduced in Hong Kong (1983), Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia (1998).

A currency board is expected to help create a credible policy environment by eliminating the option of financing government deficits through money creation. Even countries which do not fit the traditional "optimum currency area" criteria very well have benefited from the introduction of currency boards. Hence, supporters of currency boards have recently pushed for their wider use, specifically, in Indonesia, Russia, and the Ukraine. Adoption of a

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