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Policy focus

# Exchange rate regimes and capital mobility: issues and some lessons from central and eastern European applicant countries<sup>☆</sup>

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## Abstract

The five most advanced central and eastern European countries that aspire to join the European Union, EMU and to adopt the euro, have pursued very dissimilar exchange rate strategies up to now. Yet, there is only one instance in which a country was unable to sustain its chosen exchange rate regime. This paper explores two keys to exchange rate sustainability and argues that failure to maintain internal policy consistency and policy credibility is decisive in forced exit. The paper then relates the findings to possible policy lessons for emerging market economies in the Western Hemisphere. © 2000 Elsevier Science Inc. All rights reserved.

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## 1. Introduction

Interest in the appropriateness of various exchange rate regimes has surged in the last decade, in response to three major and interrelated developments. First, capital account liberalization has made capital more mobile internationally including capital surges and

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reversals associated with the integration of financial markets. Second, a number of exchange rate and payments crises, including the ERM crises of 1992/1993, the Mexican crisis of 1995 and the Asian crises of 1997/1998, has added to financial instability. Third, aspiration of central and eastern European countries to join European Economic and Monetary Union (EMU) and ultimately to adopt the euro has raised questions about the optimal transition regime. This paper explores certain issues raised by these developments and considers some lessons for emerging market economies implicit in the recent experience of the eastern European economies.

The paper is organized as follows: Section 2 provides some background on the developments noted above, while Section 3 sketches the initial transition phase and the first ten years of transition. In Section 4, two keys to exchange rate sustainability—internal policy consistency and policy credibility—are explored and put into the European context, where the experiences of Austria and Finland with financial market deregulation and liberalization are especially instructive and relevant to the (smaller) countries in the Western Hemisphere. Section 5 provides a comparative evaluation of pegs and currency boards, while Section 6 examines the effect of preparations for currency union on the sustainability of a regime of pegged rates. Section 7 concludes with some policy lessons.

## **2. Some background to the issues**

The recent experience with capital surges and reversals has led to a reassessment of the vulnerability of various exchange-rate regimes under conditions of high capital mobility and to re-examination of the optimal sequencing of the liberalization of balance of payments transactions in general and of capital account transactions in particular. While a multitude of exchange rate regimes coexists today among reform countries and other emerging economies, the many crises around the world involving adjustable peg systems have led many observers to suggest that viable regimes may be limited to the “corner solutions” of fixed pegs like the currency board, on the one hand, and free floating, on the other.<sup>1</sup> This so-called Anglo-Saxon approach views hard pegs as providing a simple commitment technology that effectively constrains economic policy and contains a built-in mechanism ensuring high exit costs. This is believed to bolster credibility and discourage speculative attacks. On the other end of the spectrum, flexible exchange rates inherently shield the economy from such attacks. However, the greater volatility of rates tends to make the flexible exchange rate option very costly for smaller (emerging market) economies.

In contrast, the continental European view is less skeptical about “intermediate” or adjustable peg systems. This view emphasizes the relative smallness of many economies, their close trade relations with the pegging partner, consistency among macroeconomic policies, the role of microeconomic reforms, and the importance of political aspirations towards EU and EMU membership. These features are viewed as providing the basis for sustainable pegs. An example of this view is Bofinger and Wollmershäuser (2000, 22), who argue that for the central European applicant countries “a flexible exchange rate target with a relatively wide band is the safest policy option.”

These considerations suggest that there is no clear-cut a priori choice for an exchange rate

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