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Exchange Rate Regimes of Developing Countries: Global Context and Individual Choices[1]

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This paper argues that, in analyzing the choice of exchange rate regimes in developing and transition countries in the present global economic context, it is essential to distinguish between those countries with substantial involvement in international financial markets and those where involvement is limited. For developing countries with important linkages to modern global capital markets, an important lesson of the recent crises in emerging market countries is that the requirements for sustaining pegged exchange rate regimes have become significantly more demanding. For many emerging market countries, therefore, regimes that allow substantial actual exchange rate flexibility are probably desirable. If supported by the requisite policy discipline and institutional structures, however, hard currency pegs may also be appropriate for some of these countries. Beyond the emerging markets countries, for many developing countries with less linkage to global capital markets, traditional exchange rate pegs and intermediate regimes are more viable and retain important advantages. *J. Japan. Int. Econ.*, March 2001, **15**(4), pp. 68–101. Research Department, International Monetary Fund, Washington, DC, 20431. © 2001 Academic Press

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I. INTRODUCTION

The exchange and payments crises of the 1990s, the general increase in capital mobility, and the boom–bust character of capital flows to developing countries

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have raised anew the issue of appropriate exchange rate arrangements. In response to these developments, an increasingly fashionable (and forcefully proposed) view has emerged, that countries should either let their exchange rates float freely or peg them firmly to a stable currency (Eichengreen, 1998; Obstfeld and Rogoff, 1995), with some authors advancing the proposition that in many developing countries only currency boards or dollarization would be sensible choices (Calvo, 1999; Hausman *et al.*, 1999). Yet another view is that on this issue not much has changed, i.e., that intermediate regimes between the extremes of pure floating and rigid fixity generally continue to be appropriate (Frankel, 1999).

This paper reviews the exchange rate regime choice of developing and transition countries in the context of the present economic and financial characteristics of these countries and of the world economy. The countries whose exchange arrangements are the subject of this paper cover a very broad range of economic development, from the very poorest to newly industrialized economies with relatively high per capita incomes. Correlated with the level of economic development, but not perfectly so, are both the degree of domestic financial sophistication and the extent of involvement with the global financial markets. The 30 or so countries that are most advanced in this last regard are what are commonly referred to as the *emerging markets*.

The paper argues that, in analyzing the choice of exchange rate regimes in developing and transition countries in the present global economic context, it is essential to distinguish between those countries with substantial involvement in international financial markets and those where involvement is limited. For developing countries with important linkages to modern global capital markets, an important lesson of the recent crises in emerging market countries is indeed that the requirements for sustaining pegged exchange rate regimes have become significantly more demanding. For many emerging market countries, therefore, regimes that allow substantial actual exchange rate flexibility are probably desirable. If supported by the requisite policy discipline and institutional structures, however, hard currency pegs may also be appropriate for some of these countries.

Beyond the emerging market countries, for many developing countries with less linkage to global capital markets, traditional exchange rate pegs and intermediate regimes are more viable and retain important advantages. Exchange rate pegs can provide a useful and credible nominal anchor for monetary policy and avoid many of the complexities and institutional requirements for establishing an alternative anchor (such as a credible inflation target backed by an operationally independent central bank). In addition, in the absence of sophisticated financial systems, many of these countries lack a deep and broad market for foreign exchange, which can provide reasonable exchange rate stability in the absence of official guidance. Exchange rate pegs can also be particularly attractive for countries with a dominant trading partner that maintains a stable monetary policy. Finally, the few developing countries that still confront the problem of stabilizing from very high inflation may also find virtue in exchange-rate-based stabilization plans, while giving due

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