



**INTRODUCTORY STATEMENT BY MR. JOSE ANTONIO OCAMPO, ECLAC'S
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Since the fall of the Bretton Woods adjustable peg arrangements, the economic histories of both the developed and emerging economies have showed tremendous theoretical and policy changes in the field of exchange rate regimes. Not surprisingly, the debate on optimal choices of exchange rate system has evolved in response to the changes of the international financial system and the functioning of domestic economies.

The first two decades after the Second World War were characterized by strict controls on capital flows, fixed but adjustable exchange rates, low inflation, rapid growth and booming international trade. In such an environment, key issues were the effects of trade, including terms of trade shocks, on exchange rates, and how to adjust the system to economies, like those of Latin American, that experienced persistent inflationary experiences, through mechanisms such as the crawling peg. In parallel, the political efforts towards increasing integration of the European economies –which culminated in the European Monetary Union many decades later– raised the theoretical questions related to the potential problems and benefits of optimal currency areas, a debate that won Robert Mundell the Nobel Price.

In the 1970s, the resumption of inflation, the slowdown of growth and the breakdown of the Bretton Woods system of adjustable pegs led the debate to shift in different directions. Initially the debate still concentrated on stabilization issues. This, together with the coincidence of twin fiscal and balance of payment deficits, was an especially hot subject in Latin America, as reflected in the debate on the monetary approach to the balance of payment.

But the breakdown of the Bretton Woods system also inaugurated a period of financial deregulation of domestic economies and reductions of barriers to financial flows, first in the developed economies, then in what would become to be known as emerging countries. The rapid growth of international financial markets and the increasing cross-border holdings of real and financial assets –something commonly referred to as “financial globalization”– led to another practical and theoretical issue: portfolio allocation by economic agents in mature economies has now profound effects on capital flows, and thus on external and internal macroeconomic and financial stability of developing countries.

This trend was particularly acute in Latin America and the Caribbean. As we know, the region experienced a capital account boom in the 1970s, followed by the debt crisis, and again sharp capital account cycles in the 1990s. In less than a decade, it underwent three adverse shocks: those associated to the Mexican crisis of 1994/1995, the Asian and Russian crises of 1997-1998, and the international recession of 2001. Moreover, the strong risk aversion to investing in developing countries since the Asian crisis, has been reflected in a reduction in the growth rate of the region to just 1.5% a year in 1998-2002, and thus to a stagnation of per-capita incomes and a rise in poverty.

Faced with the consequences of volatility, the debate on exchange rate regimes became increasingly concerned with the need of mitigating the potential deleterious effects of abrupt changes of the direction of capital flows. The succession of crises in the second half of the 1990s has led to a polarization of the debate, coined as the "corner solutions": either hard pegs, or free floating without central bank interference. Nevertheless, as we are unfortunately observing, these corner solutions have showed that they generate as many problems as "solutions" for emerging economies and their regional partners. Indeed, extreme solutions give a simple but incomplete answer to the conflicting demands that exchange rate regimes face in today's open developing economies, which are not easily reconcilable.

The first is the demand for stability, which comes from trade, but also from the capital account and domestic price stability. Given the central role that exports play in the

growth process, stable and competitive real exchange rates are essential for sustained economic growth. From the point of view of the capital account, a “hard” peg is seen as a useful instrument to avoid the pro-cyclical wealth effects of exchange rate fluctuations in countries having significant liabilities denominated in foreign currencies. From the point of view of anti-inflationary programs, it is associated with the need to anchor the price level as part of a shock therapy administered after a period of run-away inflation or, more generally, to guarantee macroeconomic discipline and price stability in small open economies. It should be emphasized that the last two demands for stability may be inconsistent with the demand deriving from trade. Thus, hard pegs and exchange rate anchors have frequently led to overvalued exchange rates that run counter to the objective of international competitiveness.

The second is a demand for macroeconomic flexibility in the face of frequent trade and capital account shocks. On the trade side, exchange rate flexibility has traditionally been seen as a useful instrument to accelerate relative price adjustments in the face of significant changes in the terms of trade and external demand conditions, or to maintain competitiveness in the face of changes in the exchange rates of major currencies or those of major trading partners. Similarly, significant changes in the availability of external financing generate a demand for flexible macroeconomic variables to absorb the positive and negative shocks that they generate. This demand for flexibility explains the fairly broad trends toward greater exchange rate flexibility that have characterized the world economy since the breakdown of the dollar standard in the early 1970s.

The relevance of these conflicting demands is not captured in the call to adopt polar exchange rate regimes. Indeed, the case for extreme regimes is based on the call to recognize that policy autonomy is quite limited in today’s world and, thus, that any attempt to manage the conflicting demands on exchange rate policy should be given up altogether.

Hard pegs certainly introduce built-in institutional arrangements that provide for fiscal and monetary discipline, but they reduce and may even eliminate the room for

stabilizing monetary and credit policies. Overvaluation in a currency board regime may thus lead to low structural rates of growth mixed with strong business cycles, a fact which coincides with the history of Argentina since the Tequila crisis. On the other hand, the volatility characteristic of freely floating exchange rate regimes increases the costs of trade transactions, thus reducing the benefits of international specialization. As developing countries are large net importers of capital goods, exchange rate uncertainty also affects investment decisions.

On the contrary, the pro-cyclical wealth effects of exchange rate variations are particularly severe in capital-importing countries. Flexibility certainly deters some short-term flows --particularly portfolio flows and short-term domestic currency-denominated debt-- but it is unlikely to smooth out medium-term capital account cycles. Rather, it could enhance them, as the significant capital gains and losses associated

The ability of a flexible exchange rate regime to smooth out the effects of externally-generated boom-bust cycles thus depends on the capacity to effectively manage a counter-cyclical monetary and credit policy without accentuating pro-cyclical exchange rate patterns. As is well known, this can be achieved through two alternative mechanisms. The first is sterilized intervention in the foreign exchange market, which involves an active management of international reserves. The disadvantage of this system is that counter-cyclical monetary policy encourages both speculative capital inflows during booms, and capital outflows during crisis, thus actually enhancing the capital account cycle. The second is managed exchange rate flexibility, in which sterilized intervention is mixed with signaling and, particularly, capital account regulations that help to overcome these problems.

Both of these options for intermediate regimes are attempts to reconcile the contradictory demands that exchange rate systems face today. Indeed, the recent history of Latin America indicates that all flexible regimes have some elements of intervention, at least under conditions that are seen as critical by central bank authorities, such as a strong devaluation pressure that may influence the price level. One of the advantages of these intermediate regimes is that flexibility can be graduated, depending on external

conditions. This implies that any specific intermediate regime has an embedded "exit option". This is, in fact, an essential feature that differentiates these intermediate regimes from any fixed exchange rate regime, hard or soft, since the latter lacks such an option and thus generates high exit costs. It can also be graduated to other specific features of the economies that affect the optimal exchange rate regime, such as size and the depth of its domestic foreign exchange and financial markets.

Overall, the experience accumulated in Latin America in recent years indicates that when exchange rate flexibility is available before an external crisis hits, it provides scope for the management of domestic interest rates in a more autonomous way. This is also true when intermediate regimes are graduated to generate more flexibility. On the other hand, when flexibility is adopted as part of a shock treatment that is undertaken when a soft or hard peg regime, or an exchange rate band, breaks down, this result is only achieved after a temporary period of turbulence. However, flexibility does not isolate the economies from real external shocks, and the mix of lower interest rates and adverse wealth effects of devaluation has unclear effects on economic activity. Finally, policy autonomy during periods of abundant capital flows has only been achieved when supported by capital account regulations, but the effects have been transitory.

Let me say, finally, that the discussion is now entering into a new phase. Confronted to global challenges, national policies are not enough and should be complemented with two other level of policy making: the regional and the international. In particular, there should be more common responses to global challenges, including policy dialogue and co-ordination of national macroeconomic policies at regional level, and reforming the international financial and trade architecture.

This conference is particularly timely and relevant in this context: the dense program of work that we have for the next two days will cover all the relevant theoretical aspects related to the optimality and sustainability of exchange rate regimes in open and interconnected economies. The analysis of concrete case studies from industrialized and emerging economies will complete the conceptual research on the relationship between exchange rate regimes, macroeconomic, trade and financial policies.

Particularly symbolic for CEPAL, which is both a regional organization and part of the United Nations Secretariat, is the emphasis of this Conference on co-operative solution to the question of optimal exchange rate regimes, a problem that was long considered as a purely national issue and –unfortunately– often analyzed as a zero sum game in the regional context.

Thanks to the advance made by the academic community, and thanks also to the pioneering project of the European Community, the creation of Regional Currency Areas and the coordination of national macroeconomic policies towards the achievement of greater regional integration is a credible alternative to confront together the challenge of attaining high and stable growth in a world economy.