VI Summary and Conclusions

The conduct of exchange rate policy in the developing countries has undergone a marked evolution over the past decade and a half. Fluctuations in exchange rates of major currencies, as well as an upsurge of inflation within the developing countries themselves, have required more frequent adjustments in exchange rates in these countries. Moreover, during the same period, a variety of adverse external shocks have depreciated the equilibrium real exchange rates of many developing countries. The combination of all these factors has resulted in a pronounced shift in the pattern of exchange rate regimes adopted by the developing countries toward more flexible arrangements, and in more frequent devaluations—either discrete or as part of a rule—in those countries that have retained a pegged regime.

A review of the theoretical literature has identified a number of criteria for choosing an optimal exchange rate to stabilize the economy in the face of transitory shocks. These criteria include the specific objective function of the authorities, the nature of exogenous shocks, and the structural characteristics of the economy. In practice, however, it is difficult to apply these theoretical criteria to specific cases owing to problems associated with the identification of the external shocks and the potential conflict among various policy objectives.

To the extent that for many developing countries the balance of payments is a binding constraint, their exchange rate policy needs to be aimed at protecting external competitiveness. In general, movements of real exchange rate indices provide critical information for assessing competitiveness. However, the fact that the equilibrium real exchange rate is affected significantly by various domestic and external shocks has obvious implications for real exchange rate rules adopted by a number of developing countries in recent years. These rules are designed to maintain external competitiveness by adjusting the nominal exchange rate in line with the differential between domestic and foreign inflation. The authorities' persistence in maintaining a real exchange rate target, however, may indeed be destabilizing if the equilibrium real exchange rate is changing, even if this target is set correctly at the outset of a program. Another adverse consequence of a real exchange rate rule is that it may leave a small open economy without a nominal anchor for domestic prices, possibly generating a high rate of domestic inflation. Thus, it seems desirable to retain a role for the exchange rate as a nominal anchor by requiring that at least some of the burden of adjustment in the real exchange rate be borne by changes in the domestic price level brought about through restrictive financial policies, rather than by automatic adjustments in the nominal exchange rate.

A related issue is the relationship between the exchange rate arrangement and financial discipline. The experience of developing countries in the 1970s and 1980s suggests that the average rate of inflation has been lower in countries with pegged exchange rates than in countries with more flexible rates. This evidence, however, is far from conclusive. Many of the countries with a pegged regime have experienced high rates of inflation owing to a lack of adherence to appropriate financial policies, while at the same time many of the countries with a flexible arrangement have recorded low rates of inflation by adopting prudent financial policies. Therefore, the effectiveness of a pegged exchange rate arrangement in enhancing financial discipline remains open to question on empirical grounds.

On theoretical grounds, the recent macroeconomic literature suggests some general principles for assessing the relationship between financial discipline and the exchange rate arrangement. A pegged exchange rate would be viable only if the public sector is perceived to be financially solvent over the longer term—that is, the present value of anticipated primary surpluses of the public sector plus seigniorage is at least as great as the face value of the public sector's net debt. To the extent that the solvency condition is not satisfied and other fiscal adjustments are not forthcoming, the government would have to rely on the inflation tax, as it would no longer be able to borrow abroad. The consequent acceleration of domestic inflation and

the decline in international reserves would lead to recurrent devaluations.

The above discussion demonstrates that a pegged arrangement does not necessarily impose financial discipline so long as the government retains the option of periodically devaluing the currency. To the extent that the government has an incentive to attempt to increase the level of output through generating unanticipated inflation, there is an inherent tendency in the system to produce bursts of inflation and recurrent devaluations. The benefits of unexpected inflation, however, would disappear as the public comes to expect the government to engineer inflation surprises. In such an environment, the government could increase social welfare if it can commit itself to price stability in a credible fashion.

Establishing the credibility of the government's commitment to financial discipline is difficult for countries with a long history of expansionary policies and high inflation. In such cases, it may be desirable for the authorities to precommit to a policy of price stability by making it costly to alter the exchange rate. An effective means to achieve this would be to enter into a currency union arrangement. Such a rigid arrangement, however, may prove to be too costly as it would preclude exchange rate adjustments even in the event of large real shocks, such as a substantial deterioration in the terms of trade. An alternative arrangement would be to grant considerable autonomy to a central bank that has a reputation for having a strong bias in favor of price stability and fixed exchange rates, without ruling out the possibility of an exchange rate adjustment in exceptional circumstances.

In view of the above discussion, it is clear that analytical arguments do not support uniform policy prescriptions for exchange rate management. The specific country circumstances will enter into the picture in an important way to guide exchange rate policies. Nevertheless, the issues discussed in this paper lead to several general observations relating to the role of exchange rate arrangements in enhancing financial stability and adjustment in developing countries.

First, in a country with a well-established reputation for financial discipline, it is of small consequence whether a pegged or a flexible exchange rate regime is maintained. By contrast, in a country lacking financial discipline, serious macroeconomic problems would emerge regardless of the exchange rate regime in operation. A fixed exchange rate would not, in and of itself, impose financial discipline, and, in fact, would compound these macroeconomic problems because of the loss of external competitiveness associated with domestic inflation.

Second, most developing countries undertaking adjustment programs fall in between these polar cases. Consequently, in adopting measures to improve external competitiveness, these countries need to strike an appropriate balance between restrictive financial policies and exchange rate adjustment. Such a balance must take into account the relative short-term costs associated with restrictive financial policies, on the one hand, and those associated with devaluation, on the other hand. In general, it is difficult to envisage a situation in which a substantial overvaluation of the real exchange rate can be corrected entirely by restrictive financial policies and without any exchange rate adjustment.

Third, a more difficult issue relates to the management of the exchange rate after the level of external competitiveness has been corrected at the outset of an adjustment program. In countries in which the authorities are not in a position to refrain completely from resorting to inflationary finance, a certain degree of flexibility in the exchange rate will be needed to prevent a deterioration in external competitiveness. This flexibility, however, should not become a substitute for undertaking as strong an effort as possible to implement prudent financial policies.

Fourth, while arguing for some degree of flexibility, the analysis provided in this paper suggests that real exchange rate rules designed to protect external competitiveness by rigidly linking exchange rate adjustment to domestic inflation could be destabilizing and even lead to hyperinflation. Rules can, under some circumstances, reduce the incentives for financial discipline. An effective arrangement for countries that need to rely on a moderate inflation tax would be to devise a nominal exchange rate rule, under which the rate of the crawl of the nominal exchange rate is fixed. Under such an arrangement, the authorities would be compelled to put in place appropriate financial policies to contain the inflation rate to a level consistent with the predetermined rate of devaluation.

Finally, when the authorities are genuinely determined to establish financial discipline and price stability, but lack credibility because of their past record, a commitment to fix the nominal exchange rate for an extended period would help provide a strong anchor for price stability.