What exchange rate and monetary regime a country should choose is a perennial question for many governments. It is especially relevant in Latin America, where many of the previously tried solutions are falling out of favor. In the 1980s, intermediate regimes such as soft pegs, crawling pegs, and crawling bands were popular. Now, these options are increasingly being discarded. This is particularly so in financially open emerging market countries, which have found that intermediate regimes are prone to crises. The resulting innovations have produced some of the most informative experiences with respect to exchange rate and monetary regimes.

The declining popularity of intermediate regimes is also related to the worldwide decline in inflation. Pegs (including currency boards) often proved to be effective in stopping inflation, particularly hyperinflation. For countries wishing to preserve some exchange rate flexibility, intermediate regimes were intended to keep a lid on devaluation and inflation expectations through bands and pegs and to prevent gradual losses of competitiveness by letting the rate “crawl.” With inflation generally under control in the region, intermediate regimes now seem less necessary.

Over the past decade, most Latin American countries have moved away from intermediate exchange rate regimes toward either one or the other extreme: floating rates or hard pegs such as currency boards or dollarization (see Table 1). Ecuador and El Salvador have adopted the U.S. dollar as legal tender. Chile staged a gradual and orderly exit from an intermediate exchange rate system to a float. Other changes in exchange rate regimes took place under crisis or near-crisis circumstances. Brazil, Mexico, and Venezuela moved to floats under pressure of heavy speculative attacks on their currencies. In early 2002, Argentina’s 11-year-old currency board system collapsed during an intense financial crisis. After an initial drop, the exchange rate has displayed reasonable stability, and the Argentine central bank recently announced its intention to pursue a floating exchange rate in the context of an inflation-targeting regime. This move away from interme-
diate regimes raises the question of what the best solution is. Are Latin American countries better off with a floating exchange rate, or should they look at other approaches, such as dollarization or a common currency for the region?

Would a common currency work?

The appeal of a supranational currency is that it may enhance monetary credibility, financial stability, and economic integration. One possibility is for the Latin American countries to form an independent currency union along the lines of the European Economic and Monetary Union (EMU). Another possibility is the adoption of the U.S. dollar by all Latin American countries. Whether either of these arrangements is feasible depends on patterns of trade, the similarity of the economic conditions, and the level of political and institutional considerations.

Patterns of trade. Countries that trade a lot with each other benefit most from the reduction in transaction costs and uncertainty that a common currency would bring. Latin American countries are less open to international trade than are other countries at a similar level of economic development, and trade within the region is lower than it is within other regions such as the EMU. Latin American countries’ trade patterns are highly diversified, with no dominant trading partner: the share of trade with the United States is often no larger or only slightly larger than that with Europe, Mexico, with an 80 percent trade share with the United States, is a notable exception.

Correlations of economic growth. If countries often share similar economic conditions, they also tend to require similar monetary policies, in which case the constraint imposed by a common currency is not costly. Latin American countries do not share markedly similar business cycles. Correlations of economic growth across pairs of countries are typically lower in Latin America than they are in Western Europe, although somewhat higher than in East Asia. For Latin American countries, correlations with U.S. growth are generally positive and often significant. However, this is also true for East Asian countries and even more so for Western European countries.

Financial considerations. There is a widespread view that financial markets tend to treat Latin American countries as one bloc. If Latin American countries were routinely hit by large, common financial shocks (such as a sudden loss of appetite for Latin American financial assets, regardless of fundamentals), a common monetary policy response would fit all countries. To assess the importance of this issue, we analyzed cross-country correlations of the following variables: interest rate spreads vis-à-vis U.S. government bonds on emerging market government bonds issued in U.S. dollars; forward exchange rates; and the estimated probability of crisis derived from an early warning system model designed to predict exchange rate crises (a way of summarizing market pressures on the exchange rate). We found that the degree of comovement of financial variables is not higher among Latin American countries than it is among emerging markets more generally. In other words, market participants may view emerging markets as one bloc, but they do not seem to view Latin American markets as distinct from the rest.

Political and institutional considerations. The European experience highlights the need for political commitment to a common currency and the time it may take to develop common institutions to support adjustment to the resulting economic and political pressures. Latin American countries have not yet made comparable investments in common institutions. Moreover, EMU countries have similar levels of economic and financial development. This made it easier to set up a union without engendering pressures for massive fiscal transfers or migration on a scale that might prove socially unsustainable. Differences in levels of development are large within Latin America, suggesting that the establishment of a common currency is not costly. Latin American countries do not seem to view Latin American markets as distinct from the rest.

On the whole, under current conditions, the economic case for an independent common currency for Latin America is weak. This may change. For example, initiatives to increase trade integration among Latin American countries would increase the appeal of a common currency. Nonetheless, an
Independent common currency in Latin America is not likely to emerge in the next decade.

**Unilateral dollarization**

Adopting the U.S. dollar as the domestic legal tender is an alternative method to "import" monetary stability and credibility. Ecuador and El Salvador have dollarized recently; Panama has used the U.S. dollar since 1904. In this context "dollarization" means the official adoption of a foreign currency as legal tender, not informal or de facto dollarization in which a foreign currency circulates concurrently with the domestic currency and may be used to denominate bank accounts or other financial assets.

Because dollarization is unilateral, it does not require a long process of building common institutions and reaching consensus, although it precludes the dollarized Latin American countries from having a say in U.S. monetary policy or, more important, from benefiting from the supervision— and backing— of the domestic financial system by the U.S. Federal Reserve System. Of course, a country that chooses to adopt the U.S. dollar abandons the possibility of setting its own monetary policy in response to the domestic economy and loses to the foreign central bank the profits that its central bank makes by printing money ("seigniorage").

For many countries, the main gain from dollarization would be to neutralize the domestic monetary institutions' poor credibility, which may have been caused by past violations of exchange rate pegs, a history of monetary financing of the fiscal deficit or the banking system, and high inflation. Poor monetary credibility makes all exchange rate systems difficult to operate. Pegs or intermediate regimes result in high interest rates, which hurt private investment and challenge fiscal sustainability; floating exchange rates suffer from high volatility and episodes of overshooting.

While there has been evident progress in strengthening monetary management in Latin America, it often takes years to establish credibility. A manifestation of a lack of monetary credibility is that citizens want to hold their savings in U.S. dollars, not domestic currency. One form of this is capital flight; another is the holding of a large fraction of domestic monetary assets (bank deposits and cash) in foreign currency, a sort of "spontaneous" dollarization. In this regard, foreign currency-denominated bank deposits are large in many Latin American countries, particularly in Bolivia, Peru, and Uruguay (see Table 2). One important implication of extensive spontaneous dollarization is that large changes in the exchange rate can bring about a financial crisis and large-scale bankruptcies among corporations with foreign currency exposure.

Latin American countries choosing to dollarize unilaterally could obtain other significant side benefits, notably expanded relations with the United States in the areas of trade, foreign direct investment, and financial market integration. But, on the whole, dollarization may be appealing only to small countries with close links to the United States, a high degree of spontaneous dollarization, and low central bank credibility. The most likely candidates tend to be in Central America.

**Is floating the answer?**

Are floating rates viable options for Latin America? Can flexibility in exchange rates and independent monetary policy achieve meaningful domestic objectives, such as more stable output? Or is it the worst of both worlds, with low credibility and little true discretion?

Recent experience in Latin America and elsewhere suggests that floating regimes do allow exchange rates to move appropriately in response to shocks, although sometimes interest rate responses are also sharp. Exchange rate flexibility seems to have been helpful in cushioning output changes in the face of adverse shocks, and pass-through to inflation has been fairly low. It appears also that floating regimes are gradually becoming more effective.

For example, compare how Mexico and Argentina responded to the turmoil created by the crises of 1998/1999— Russia, Long-Term Capital Management, and Brazil (see chart). In Argentina, with a still credible currency board, both the exchange rate and interest rates remained flat, but the economy entered a prolonged depression. In Mexico, by contrast, interest rates spiked, but the exchange rate also weakened substantially, thereby buffering the effects of the adverse external environment on growth. Real GDP growth dipped briefly but resumed in 1999, and the exchange rate rose rapidly again. Interest rates have since come down steadily, partially mitigating the impact of the U.S. slowdown.

An examination of the recent history of floating exchange rate regimes, such as those in Chile, Mexico, and Peru, suggests that they may become more effective with time, as...
Comparing impacts
Exchange rate flexibility cushioned Mexico against the impact of external shocks during 1998/99.

- Argentina
- Mexico

Real exchange rate

Real GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Real exchange rate</th>
<th>Real GDP</th>
</tr>
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<tbody>
<tr>
<td>1996</td>
<td>-10</td>
<td>-8</td>
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<tr>
<td>1997</td>
<td>-5</td>
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<td>12</td>
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<tr>
<td>2001</td>
<td>15</td>
<td>15</td>
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Sources: IMF, International Financial Statistics (various years), and staff estimates.

credibility increases and the system becomes more firmly established. Chile went through two episodes of exchange rate pressure, in late 1998 and late 2000. In the first, interest rates increased sharply, in the context of a monetary framework with objectives on both inflation and the exchange rate (an explicit band), and the economy went into a sharp recession. In September 2000, the authorities abandoned the band for freer floating, and the resulting sharp depreciation was not accompanied by any interest rate increases. There was no recession, and inflation increased only slightly. One can perhaps infer from this experience that Chile accrued credibility in 1998 and used it successfully in 2000 to “float without fear.”

The increasing success of floating regimes is also supported by more systematic evidence. Econometric estimates of monetary policy reaction functions (how the central bank adjusts interest rates in response to changes in economic conditions) have been used to determine whether countries with floating exchange rates are able to raise and lower their interest rates in response to changing domestic circumstances. Do countries lower rates when inflation is below target or when unemployment is too high, or do pressures from financial markets prevent them from doing so? Evidence from the few countries (such as Chile and Colombia) with a sufficiently long history of floating exchange rates suggests that they have been able to move interest rates in useful ways to counteract changes in domestic economic conditions.

Another characteristic of a well-functioning floating exchange rate is that it responds appropriately to external shocks. When the terms of trade decline, for example, it makes sense for the country’s nominal exchange rate to weaken, thereby facilitating the required relative price adjustment. Emerging market floating exchange rate countries do, in fact, react in this way to negative terms of trade shocks. In a large sample of developing countries over the past three decades, countries that have fixed exchange rate regimes and that face negative terms of trade shocks achieve real exchange rate depreciations only with a lag of two years while suffering large real GDP declines. By contrast, countries with floating rates display large nominal and real depreciations on impact and later suffer some inflation but much smaller output losses.

Floats aid adjustment
An independent common currency does not seem appropriate for Latin America because the necessary degree of political and economic integration is absent. Dollarization may be appealing for a few smaller countries. But many countries could benefit from the flexibility of a floating exchange rate regime despite substantial credibility problems, in part because the countries are relatively large and closed and have no single dominant economic partner. In practice, emerging market floats are seldom “pure”: the authorities often intervene in the foreign exchange market and conduct monetary policy with a close watch on pressures from international financial markets. Floats do, however, seem to facilitate adjustment to shocks and allow the use of autonomous monetary policy. On the whole, several countries in the region are good candidates for floating meaningfully and beneficially, without paying large costs in terms of lost credibility or increased volatility.

Success with a given regime may make it more and more viable over time. Dollarization may promote further trade and financial integration with the United States. If floating regimes deliver low inflation and strengthen credibility, indexation may decline and expectations may become more forward-looking. Firms may be able to reduce their vulnerability to exchange rate fluctuations by altering their financial structure to minimize balance sheet effects. And inflation pass-through may decline.

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