I Overview

The exchange rate regimes in today's international monetary and financial system, and the system itself, are profoundly different in conception and functioning from those envisaged at the 1944 meeting of Bretton Woods establishing the IMF and the World Bank. The conceptual foundation of that system was of fixed but adjustable exchange rates to avoid the undue volatility thought to characterize floating exchange rates and to prevent competitive depreciations, while permitting enough flexibility to adjust to fundamental disequilibrium under international supervision. Capital flows were expected to play only a limited role in financing payments imbalances and widespread use of controls would insulate the real economy from instability arising from short-term capital flows. Temporary official financing of payments imbalances, mainly through the IMF, would smooth the adjustment process and avoid undue disturbances to current accounts, trade flows, output, and employment.

In the current system, exchange rates among the major currencies fluctuate in response to market forces, with significant short-run volatility and occasional large medium-run swings. International private capital flows finance substantial current account imbalances, and fluctuations in these flows appear to be either a cause of major macroeconomic disturbances or an important channel through which they are transmitted to the international system. The industrial countries have generally abandoned control and emerging market economies have gradually moved away from them.

Three features of the modern international monetary and financial environment are particularly noteworthy. First, the revolution in telecommunications and information technology has dramatically lowered transaction costs in financial markets and spurred financial innovation and the liberalization and deregulation of domestic and international financial transactions. This, in turn, has facilitated further innovation and capital market integration. As a result, capital mobility has reached levels not matched since the heyday of the gold standard:[1] obstacles to trade in assets have been dramatically reduced and capital movements are highly sensitive to risk-adjusted yield differentials and to shifts in perception of risks. Financial markets have also become globalized in the sense that the balance sheets of major financial and industrial companies around the world are increasingly interconnected through currency and capital markets. As a result, shocks to important individual markets or countries tend to have greater systemic repercussions.

Second, developing countries have been increasingly drawn into the integrating world economy, in terms of both their trade in goods and services and in financial assets. As a consequence, these countries have been able to reap many of the benefits of globalization. However, they also have become more exposed to some of its risks and dangers, notably to abrupt reversals in capital flows. At the same time, private capital flows have come to play a dominant role in emerging economies' financing and adjustment.

Third, the emergence of the euro may mark the beginning of a trend toward a bi- or tri-polar currency system, away from reliance on the U.S. dollar as the system's dominant currency. An important issue is whether the exchange rates between major currencies will continue to exhibit the wide swings and occasional misalignments that characterized the 1980s and 1990s. This is an important issue for the system as a whole because such swings have important repercussions for third countries—developing countries, in particular. For the latter, a wide variety of exchange rate arrangements prevail, with a tendency to move toward increased exchange rate flexibility.

This paper examines the consequences of heightened capital mobility and of the integration of developing economies in increasingly globalized goods

[1]See, for instance, Obstfeld (1995b). A comparison with the pre-World War I gold standard period is complicated by very high labor migration, which has not been approached in the recent era, as well as strong cultural and political ties between the main lending country (the United Kingdom) and two of the largest recipients (Australia and Canada).

and financial markets for the exchange rate regimes both of the world's major currencies and of developing and transition countries. Section II discusses exchange rates of the major countries' currencies, and concludes that the exchange rates among the euro, the yen, and the dollar are likely to continue to exhibit significant volatility. (These currency areas are large and relatively closed, and Appendix I provides some evidence that such areas are likely to exhibit greater exchange rate volatility than small, relatively open, economies.) Section II also briefly examines various schemes to moderate such fluctuations, and concludes that these schemes are neither likely to be adopted, nor to be desirable under current circumstances, although a case can be made for monitoring potential major misalignments within the IMF's surveillance process. The section finishes with a discussion of key lessons from the experiences of the medium-sized industrial countries, whose exchange rate regimes, in an environment of increasing capital market integration, have moved increasingly toward either hard pegs (especially in the case of the participants in European Economic and Monetary Union—EMU) or to market-determined floating rates.

Section III reviews the economic environment facing developing and transition countries—including heightened capital mobility, continued exposure to exchange rate risk, increased openness to international trade, a shift of exports toward manufactures, greater intraregional trade, and lower inflation. It then considers lessons from the recent crises in emerging market countries, concluding that for developing countries with important linkages to modern global capital markets (as for industrial countries), the requirements for sustaining pegged exchange rate regimes have become significantly more demanding. For many emerging market countries, therefore, regimes that allow substantial exchange rate flexibility are probably desirable. Some emerging market countries, of course, may go in the other direction—toward hard currency pegs (such as currency boards), supported by the requisite policy discipline and institutional structures.

Beyond the emerging markets, for many developing countries with less linkage to global capital markets, the viability and suitability of exchange rate pegs is greater. This includes some of the larger developing countries, as well as a substantial number of smaller economies (see Appendix II). 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 (see Appendix III), while giving due attention to timely implementation of an exit strategy. In contrast, several of the transition countries of Central and Eastern Europe, especially those preparing for membership in the European Union (EU) and participation in EMU, will want to establish over time the policy disciplines and institutional structures that support hard exchange rate pegs. Exchange regimes for developing countries in regional groups—notably the Association of Southeast Asian Nations (ASEAN) and the Southern Common Market (Mercosur)—with diversified trade linkages to industrial countries and important intraregional linkages raise particular problems, and a variety of potential solutions are examined. Before concluding, the section takes up important policies intimately connected with the exchange rate regime, emphasizing that countries adopting floating rates need a nominal anchor to secure the objective of low inflation.

Appendix IV reviews IMF advice to member countries on exchange rate arrangements. Consistent with the Articles of Agreement, the IMF's usual approach is to abide by a member's preferred exchange rate regime and to advise on policies needed to support that choice. Nevertheless, the IMF does sometimes question whether a country's exchange rate regime or the prevailing level of its exchange rate is consistent with the country's objectives and other policies. In the case of IMF-supported programs, the IMF lends to countries with exchange rate pegs only if its ex ante assessment is that such a policy is sustainable under the program, although there have been cases in which pegs subsequently had to be abandoned, typically in the context of policy slippages. In this regard, higher capital mobility makes more exacting the policy requirements for sustainability.