

EXCHANGE-RATE REGIMES AND MACROECONOMIC STABILITY[†]

Economic Transition and the Exchange-Rate Regime

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Exchange-rate management poses special challenges in the transition economies of Eastern Europe and the former Soviet Union. These countries are adapting to open, market-based international trade without prior experience with currency convertibility. Most are undertaking stabilization programs to end high inflation. Therefore, monetary and exchange-rate policy must be designed with an eye toward currency stabilization. They are undergoing enormous structural change, with very large movements in relative prices and productivity, so that indicators of a country's international competitiveness (e.g., relative unit labor costs, relative producer prices) provide a very imprecise guide for policy. Like many other countries in the developing world, these countries are experiencing large inflows and outflows of capital and are therefore increasingly subject to shocks emanating from world capital markets.

In this maelstrom, are there guidelines for the appropriate management of the exchange-rate regime? What kinds of numerical indicators should be uppermost in the policymaker's attention? What advice and assistance should be given by the international financial community, and most importantly, the IMF?

I. Early Exchange-Rate Management

Exchange-rate management is one of the areas of reform where optimal transitional policies may well differ from long-range operating policies. For example, there are good reasons for countries at the start of stabilization and liberalization programs to adopt a *pegged exchange-rate regime* as part of the

initial policy, even if the countries should then move to flexible-rate systems after one or two years of stabilization and liberalization.

Most of the transition economies began the shift to markets with a common set of structural imbalances: repressed inflation, marked by extreme shortages in consumer and producer markets; large fiscal deficits, including an overhang of foreign debt; extreme currency inconvertibility, including a large black-market premium on the exchange rate; low levels of domestic competitiveness; and weak trade and financial linkages with market economies, including Western Europe. In Central Europe, Czechoslovakia stood out as the sole case of a country that began the reform period without extreme prior macroeconomic instability. The financial problems of the former Soviet Union and the former Yugoslavia were greatly compounded by the sudden emergence of new nation states without separate currencies and, thereby, with multiple central banks ostensibly sharing a common currency, without overall coordination or control.

The first stage of the market reforms in almost all transition countries was the liberalization of prices, the unification of the official exchange rate and the market exchange rate, and the opening of the economy to international trade. In Poland, this was combined with strong fiscal and monetary measures, so that inflation very quickly subsided, falling from 586 percent in 1990 to 70 percent in 1991 and 43 percent in 1992. In some other countries in Eastern Europe, notably Bulgaria and Romania, monetary and fiscal policies remained lax, and triple-digit inflation persisted for several years. In Hungary, moderate inflation rates (20–40 percent per year) persisted throughout the early 1990's. In the successor states of the Soviet Union, high inflation was pandemic, reaching triple- or quadruple-digit rates in 1992 in every one of the 15 new nations.

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The practical issue facing governments and central banks was the appropriate management of the exchange rate after price liberalization, both in the immediate aftermath and in the longer term. This choice, of course, was part of a larger set of choices involving the role of the central bank, the implementation of monetary reforms (in the new nations), the scale of fiscal deficits, and their mode of financing. Four countries relied initially on pegged exchange rates: Czechoslovakia, Estonia, Hungary, and Poland. Four others relied on floating exchange rates: Kyrgyzstan, Latvia, Russia, and Ukraine. By 1994, all but Russia and Ukraine had succeeded in ending high inflation, and in carrying out other main aspects of reform.¹

Even before reaching the decision over exchange-rate regime, the successor states to the Soviet Union had to take decisions regarding a national currency. In this, the IMF made a serious mistake in early 1992, in pushing hard for the continuation of a common currency for the successor states, despite the existence of 15 separate central banks and little feasibility of monetary coordination among the separate central banks (see Sachs [1995a] for further discussion). In the spring of 1992, the IMF advised all countries that introduction of separate national currencies should be delayed for months (until the fall of 1992 at the earliest, in the case of advice to Estonia) or indefinitely. This naive advice set back stabilization by at least one year in most of the former Soviet Union, since the common currency effectively gave a license to issue credits to each of the central banks. The Russian government continued to accept the ruble credits issued by the non-Russian central banks in payment for imports from Russia and, in the end, effectively supplied up to 7 percent of Russian GDP to the other republics in net shipments financed by credits in the period April–December 1992. This 7 percent of GDP showed up in the Russian money supply and provided a financial impetus to inflation of about the same magnitude as did the central-

bank financing of the Russian budget deficit. Russia and the other successor states were able to achieve stabilization only when they became masters of their own monetary fate (i.e., only when they adopted a separate national currency not used by other countries). In Russia, full monetary independence from the other states effectively began in the fall of 1993, when Soviet currency notes were withdrawn from circulation in Russia, and republics that still lacked their own currency finally moved to establish new national currencies.

Poland established a pattern for other reform countries with its rapid introduction of convertibility on January 1, 1990. Ten Western governments joined to provide a \$1 billion zloty stabilization fund to provide reserves to defend the newly convertible currency. The zloty was devalued sharply, unified with the black-market rate, and then pegged vis-à-vis the dollar. Inflation spiked in the month of price liberalization, to 100 percent in January, and then fell to 20 percent in February, and 5 percent in March. The nominal exchange-rate peg held successfully, without resort to the stabilization fund, and was maintained until a devaluation in April 1991. Poland adopted a crawling peg in October 1991 and then a crawling band in July 1995. Czechoslovakia followed the Polish example one year later, when it devalued the koruna, established limited convertibility, and pegged the exchange rate in January 1991. Hungary eschewed a one-time step to convertibility but achieved substantial convertibility on the trade account in 1990 and, thereafter, pegged the exchange rate, with occasional devaluations.

Under IMF advice, other Eastern European economies established quick convertibility, but the IMF urged the other countries to move directly to a floating rate. Bulgaria and Romania floated their exchange rates beginning in 1990. A similar pattern played out in the former Soviet Union, once the Soviet ruble was dropped in favor of a national currency. One country, Estonia, adopted a pegged exchange rate, counter to the initial advice of the IMF (though the IMF agreed to support the Estonian position). All other countries of the former Soviet Union, under IMF tutelage, moved directly to floating-exchange-rate regimes. In early 1994, two of the initial floaters,

¹ A table summarizing the decisions taken for a representative selection of eight countries throughout the region is available from the author upon request.

Latvia and Lithuania, adopted a pegged exchange rate and currency-board arrangement in emulation of Estonia.

Extensive theoretical and empirical analysis gives three main reasons for preferring a pegged exchange rate at the outset of ending high inflation (see Michael Bruno, 1995; Sachs, 1995b, c). First, the pegged rate bolsters the government's commitment to the stabilization effort, by establishing clear, monitorable targets, and by tying the government's own hands. Second, the exchange-rate peg helps price- and wage-setters coordinate their actions and expectations around a new low-inflation equilibrium. Third, the pegged-exchange-rate system provides a convenient way for households and enterprises to rebuild their real money balances after a bout of high inflation. At the start of stabilization, economic agents find themselves desiring to hold higher real money balances. Under pegged exchange rates, these desires are satisfied automatically through the balance of payments, as agents repatriate their offshore capital and convert it into domestic currency. The central bank is committed to purchasing the repatriated capital in return for domestic money. Under a floating-rate regime, by contrast, there is no automatic mechanism for households to rebuild their real money balances, since the central bank is not obliged to purchase repatriated capital in return for domestic money (and in a pure float, it will *not* do this).

In principle, the central bank could support remonetization of the banking system by expanding *domestic* credit in line with rising demand for real money balances, but such an action is extremely hard to carry out, since domestic credit expansion by itself may undermine the credibility of the stabilization program. Therefore, many central banks refrain from domestic credit expansion, and the economy remains undermonetized, suffering from excessively high real interest rates and an overvalued currency. The result is that successful anti-inflation programs under floating rates tend to be more contractionary than those carried out under pegged exchange rates, and many attempts at stabilization under flexible rates simply fail.

The experience of the transition economies supports the diagnosis that a pegged exchange

rate is useful in the early phase of stabilization from high inflation. While it is difficult to control for all relevant macroeconomic factors in these countries, it appears that the early peggers (Czech Republic, Estonia, Hungary, Poland, and Slovakia) outperformed the floaters, both in terms of the success of disinflation and the costs of disinflation. Many floaters, such as Russia and Ukraine, were still mired in triple-digit annual inflation rates as late as 1995, while Romania only reduced inflation to double-digit rates in 1994, and Bulgaria in 1995. The early peggers all achieved inflation below 100 percent per year by 1994. The reform histories of the individual countries suggest that successful early pegging of the exchange rate in the Czech Republic, Estonia, and Poland not only supported macroeconomic stability, but actually bolstered the capacity of the governments to make progress in other areas of reform, in comparison with other countries such as Russia where failures of macroeconomic stabilization undermined reform efforts in nonmonetary aspects of the economy.

Even where stabilization under floating rates was achieved, the costs seem to be higher than in the pegged-exchange-rate stabilizations. A particularly interesting case is provided by two neighboring Baltic states, Estonia and Latvia. Estonia stabilized with a pegged exchange rate, under a currency-board arrangement, while Latvia initially relied on a floating exchange rate. Both countries in fact succeeded in ending high inflation, but Latvia experienced a much deeper and prolonged recession. At the same time, Latvia's real interest rates remained much higher, with less remonetization of the economy, and less confidence in the stability of the currency. According to the European Bank for Reconstruction and Development (1995 p. 185), Estonia's year-over-year GDP changes for 1993, 1994, and 1995, were: -7, 6, and 6, respectively. Latvia's GDP changes for the same years were -15, 2, and 1. Perhaps the proof of the pudding is in the eating: Latvia adopted a pegged-rate regime in early 1994. (For a more extensive comparison of the monetary experiences of the Baltic States, see Ardo Hansson and Sachs [1994]).

Kyrgyzstan provides another example of the weaknesses of floating-rate stabilization from high inflation. This Central Asian republic

introduced a new national currency, the som, in May 1993, replacing the shared ruble currency, which at that point was depreciating vis-à-vis the dollar at around 20–30 percent per month. The economy was deeply demonetized at the outset of the new currency, with the ratio of M2 to GDP around 4 percent. This was a clear case where remonetization was needed as part of the stabilization program. The IMF insisted upon a floating-rate regime, however, and upon domestic credit targets too low to support remonetization (under the IMF program, the M2/GDP ratio was actually targeted to decline further). The high inflation was in fact ended, but with a huge drop in real GDP, which fell by 16 percent in 1993 and 27 percent in 1994.

The reluctance of the IMF to advise in favor of pegged rates at the outset of stabilization from high inflation seems to be the result of the institution's reluctance to support the international provision of stabilization funds to countries that lack adequate foreign reserves to defend a pegged rate. In principle, a pegged rate can be defended even without initial reserves, if fundamental monetary and fiscal policies are in order, although a pegged rate unbacked by reserves is vulnerable to self-fulfilling speculative attacks. The zloty stabilization fund showed how the mere existence of reserve backing can strengthen the public's confidence in the currency, without the need to draw upon the fund. Nonetheless, in all other transition countries, the IMF has refused to support the implementation of a stabilization fund at the outset of a stabilization program. In late 1995, the IMF formally approved the possible future use of stabilization funds in IMF programs, but in practice it continued to inform countries (e.g., Ukraine) that such funds could be arranged only after inflation had been brought under control for several months.

II. Long-Term Exchange-Rate Policies

One of the greatest practical challenges of exchange-rate policy is to recognize that a policy regime appropriate for ending high inflation may well be inappropriate for long-run economic management. In particular, a pegged exchange rate can easily overlast its

usefulness and turn into a danger for the economy. The 1994 Mexican peso crisis is a stark reminder of this proposition. The Mexican government successfully used the pegged rate to end high inflation in the late 1980's but then became attached to the pegged rate as a measure of the government's overall monetary credibility during the 1990's. When a devaluation was called for in early 1994, it demurred and eventually experienced a loss of foreign reserves and a balance-of-payments crisis at the end of the year (see Sachs et al., 1996). Successful stabilizers, in most cases, began with a pegged rate and then added flexibility to the exchange-rate regime over time, as in the case of Chile, Israel, and Poland.

There are limited circumstances in which a "permanent" pegged rate is appropriate. The first is for very small open economies with a high degree of wage–price flexibility, in which nominal magnitudes can adjust readily to exogenous shocks. Hong Kong is the best case of a successful sustained pegged rate under a currency-board arrangement. The Baltic states are also plausible candidates for this kind of monetary arrangement. The second case is a true monetary union, where two or more economies constituting an optimal currency area adopt an irrevocable peg under a single currency, with a single issuer. A third case, debatably, is a country like Argentina, which over the course of decades proves incapable of managing a discretionary monetary system with low inflation and, thereby, adopts a monetary "straitjacket" in the form of a currency board and an irrevocably fixed exchange rate. Argentina's own monetary and banking crisis in 1995, in the wake of the Mexican crisis, clearly shows the costs of such a policy, even if those costs may be outweighed by the benefits of extreme monetary discipline.

In the case of the transition economies, there is a strong case for moving to a more flexible exchange-rate arrangement once high inflation has been eliminated and the economy has been substantially remonetized. The transition economies still suffer from chronic structural weaknesses that limit the flexibility of the domestic economy. These weaknesses include a

high degree of state ownership; wage-setting in state-owned enterprises strongly influenced by insiders; various inherited rigidities in wage-setting, such as strong legal or informal norms concerning relative wages across sectors of the economy; moderate rather than high openness to international markets; and chronic fiscal problems, including very high rates of taxation, resulting from the hypertrophied state sector and inherited high levels of international indebtedness in some countries. There are two main implications of these debilities. First, monetary and fiscal policies are likely to remain too expansionary in the next few years to underpin a permanently pegged rate. Second, the domestic economy is unlikely to possess the high degree of flexibility needed to absorb adverse shocks under a permanent pegged-rate system.

This suggests a monetary-policy regime in which the exchange rate is made more flexible (e.g., in a crawling band rather than a rigid peg), and in which price stability is underpinned by strengthened *domestic* monetary targets and institutions. Chile provides an illustration. Chile's exchange rate is kept within a crawling band, where the central parity of the band is adjusted monthly in line with the difference in inflation between Chile and its main trading partners. Domestic inflation targets are achieved through domestic monetary-policy instruments, undergirded by a government budget surplus and an independent central bank.

No transition economy in Eastern Europe or the former Soviet Union has explicitly adopted such a policy assignment, though Poland offers an important example of a country moving in that direction. Poland began its stabilization program with a pegged exchange rate in January 1990. After one devaluation under the pegged-rate arrangement in April 1991, it adopted a crawling peg in October 1991. In May 1995, it adopted a widened band for the crawl. It has also established central-bank independence and has worked toward strengthening underlying fiscal policies, though like most of the countries in the region, it remains burdened by a chronic fiscal deficit.

The hardest practical problem in exchange-rate management under such a policy assignment is to judge the appropriateness of the

nominal exchange-rate target (e.g., for the central parity of a crawling band) from the point of view of long-term international competitiveness. All of the transition economies began with tradable sectors with very low productivity and deep organizational disarray. Wage levels in dollar terms were consequently very low. In the past five years, productivity has begun to rise sharply in the leading reform economies, as has their export capacity. Dollar wages, as a result, have begun to rise sharply in several countries. The policy challenge lies in distinguishing between dollar-wage increases justified by rising tradables productivity, and dollar-wage increases that result from internal inflationary pressures.

The policy of simply maintaining the nominal exchange rate unchanged is likely to provoke growing overvaluation of the currency. This might already be evident in 1995 in the Czech Republic, where dollar wages have increased rapidly and export growth has slowed. A pure float, combined with tight monetary policy, on the other hand, could well lead to currency *overvaluation* in the short term. A crawling band, therefore, may avoid the dangers of currency overvaluation posed both by pegged and purely floating exchange-rate regimes.

As in many cases of stabilization and trade liberalization, the leading reform economies in Eastern Europe are currently subject to rapid capital inflows that could well subside in the next few years. The capital inflows are another source of pressures toward currency appreciation. There is still no consensus on the appropriate policy response to sharp increases in short-term capital inflows. Caution in the transition economies in removing remaining barriers to short-term capital mobility seems to be called for, especially with regard to short-term international borrowing by domestic commercial banks. The recent financial crises in Argentina, Mexico, and Venezuela demonstrate that undercapitalized banking sectors may exacerbate macroeconomic instabilities by engaging in large-scale foreign borrowing at the time of capital-market liberalization (see Sachs [1995c] for a discussion of capital controls and the risks of banking crises accompanying capital-market liberalization).

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