

# Comments on: Bordo Exchange Rate Regime Choice in Historical Perspective

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# Comments: Exchange Rate Regime Choice in Historical Perspective

- Main Results and Summary Implications
- Relevance for Emerging Markets and Arab Countries
- Directions for Research
- Policy Action: What Should We Do?

# Choices for Exchange Rate Regimes

- Post-Asian/Russian/Latin/Argentina crises policy relevance: what monetary & exchange rate arrangements?
- Standards: Specie or Fiat Money
- Exchange Rate:
  - Fixed
  - Intermediate
  - Floating

# Choices for Exchange Rate Regimes

- Choice depends on predominance of shocks, nominal v/s real and degree of capital mobility
- Mundellian criteria:
  - Nominal Shocks  $\Rightarrow$  Fixed rates
  - Real Shocks  $\Rightarrow$  Flexible Rates

# Choices for Exchange Rate Regimes

- Impossible Trinity: Pegged rates-Open Capital Markets- Monetary Independence not compatible or sustainable $\Rightarrow$ collapse  
Gold Standard and Bretton Woods
- Monetary Constitution criterion:
  - nominal anchor; peg to low inflation country
  - Pre-commitment mechanism to anchor expectations

# Exchange Rate Regime Choice Criteria

- View Exchange Rate Regime choice as attempt to resolve Time-Consistency and Credibility Problems
- Monetary Constitution/Institutional Design Problem:
  - Commodity Standards (& Currency Boards) left no choice for discretion and are transparent
  - Fiat Standard: Independent Central Banks with clear mandates to preserve monetary/price stability

# Classification & Performance

- Distinguish *de jure* from *de facto*: *countries do not do what they say they do.*
- Reinhart-Rogoff: distinguish 15 categories; main result: over 50% *de jure* floats are *de facto* pegs and half of *de jure* pegs are *de facto* floats!

# Classification & Performance: Bordo Long-Term Evidence

1880-1995, 14 industrial countries; exchange rate change, inflation, growth income per head

- Exchange Rates: most stable under gold standard
- Inflation lowest under gold standard
- No connection between exchange regime and economic growth



# Classification & Performance: Recent Evidence

- *De jure* and *de facto* evidence markedly different: official history profoundly misleading
- R&R 45% of all post 1970 pegs should be classified managed floats, limited flexibility, freely floating or “freely falling”
- In 1980s & 1990s: 53% of ‘managed floats’ were *de facto* pegs or crawling pegs

# Recent Evidence on Performance on Free Floating

## Official Classification:

- Inflation: 174%
- Growth: 0.5%

## R&R classification:

- Inflation: <10%
- Growth:  $\cong$  2.3%

# Emerging Markets

- Hard Pegs/Currency Boards: did not rule out banking/financial crises
- Problem of ‘Original Sin’: limited access to international capital markets + high costs
- High pass-through from exchange rates
- Central issue: **financial development and maturity**

# Anchors & Currency Unions: Benefits & Costs

- Secure inflation rate of anchor  $\Rightarrow$  credible price stability policy, greater financial stability
- Lower transactions costs: goods, services
- Loss of independent monetary policy/lender of last resort; depends on correlation of shocks with anchor
- Loss of seigniorage/sovereignty; but depends on seigniorage compensation arrangements

# Anchors & Currency Unions

Countries most likely to benefit:

- Unable to achieve monetary, price & financial stability
- Economic disturbances highly correlated with potential anchor
- Small countries highly dependent on foreign trade
- Countries close in ‘**distance**’ (geography, language, borders) to potential anchors and large potential multilateral trade
- Evidence: ↑trade by factor of 2 to 3

# Anchors & Optimal Currency Areas

## Alesina-Barro-Tenreyro evidence

- Pros & Cons of different anchors: US\$, Euro and Yen
- Examine alternative criteria: trade, co-movements of prices, co-movements of output

Country	Trade	VP	VY
Algeria	Euro	Euro	Euro
Iran	Euro	Euro	Euro
Jordan	Euro	US	Euro
Mauritania	Euro	Euro	<b>Euro</b>
Morocco	Euro	<b>Euro</b>	<b>Euro</b>
Oman	Euro/Jp	US	<b>Japan</b>
Saudi Ara.	Euro	<b>US</b>	US/Euro
Syria	Euro	<b>US</b>	<b>Euro</b>
UAE	Jp/Euro	US	Euro

# Key Results

- Re-think theoretical and empirical literature and paradigms on exchange rate regimes
- Floating rates have been maligned
- Focus policy on financial development: breadth, depth & liquidity of markets



# What to do, Where Should We Head? The other 'Road Map'

- Legal-Institutional: implement/revise laws to create stronger, more independent central banks, accountable for financial stability mandates
- Develop Government Bond Markets⇒ finance governments
- Strengthen links between Central Banks: financial safety net and 'Arab Target'
- GCC Monetary Union: currency is a public good
  - Link to Euro & \$
  - Foster integration