

# Briefing Notes in Economics

*'Helping to de-mystify economics since 1992'*

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## Choosing an Appropriate Exchange Rate Regime for Small and Open Emerging Economies ♦

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This paper re-visits the issue of appropriate exchange rate regimes for small and open emerging economies, many of which have been plagued by financial crises in recent years. The so-termed “hollowing out hypothesis”, “zeal for extremes” or “law of the excluded middle” draws analytical support from the principle of “Impossible Trilogy or Trinity”. Simply put, this states that a country cannot simultaneously conduct independent monetary policy and pursue a fixed exchange rate if it wants to remain open to international capital flows. But does this “hollowing out hypothesis” really stand up to careful scrutiny? This is the question we explore in this paper. It is argued that the analytical basis for this hypothesis is rather weak; neither corner of a completely fixed or a completely flexible exchange rate appears to work all that well for emerging economies. **JEL: F31.**

### 1. Introduction

An immediate lesson that many observers appear to have drawn from recent financial crises in emerging market economies in the 1990s is that the only viable exchange rate option boils down to one between flexibility, on the one hand, and “credible pegging”, on the other. According to this view, emerging economies have to gravitate to these two extremes (Figure 1). Any currency arrangements that lie in between these polar extremes (i.e. those in the “middle”) are viewed as being inherently unstable and crisis-prone. The following observation by Eichengreen (2001a) typifies the mainstream view:

‘...high capital mobility has made it exceedingly difficult...to operate pegged-but-adjustable exchange rates ... Intermediate regimes are fragile. Operating them is tantamount to painting a bull’s eye on the forehead of the central bank governor and telling speculators “shoot here”.’ (p.267).

But does this so-called “hollowing out hypothesis” or “zeal for extremes” really stand up to careful scrutiny? This is the question we explore in this paper.

A number of observers have strongly favoured the corner, as opposed to interior, solution of an irrevocably fixed regime. Such a hard peg or “straitjacket”,

the argument goes, signals greater commitment to rule out arbitrary exchange rate adjustments (i.e. “escape clauses” cannot be invoked) and the authorities’ willingness to subordinate domestic policy objectives such as output and employment growth to the maintenance of the pegged exchange rate. However, there are strong reasons as to why many countries are unwilling to go down this route. We examine some of these reasons in section 2. This appears to leave a flexible regime as the only viable option. Section 3 deliberates on the case for and against a flexible regime. To anticipate the main conclusion of these sections, while favouring relatively more flexible regimes, emerging economies have continued to heavily manage their currencies despite being officially described as “floaters”. In other words, there appears to be a definite “fear of floating”; soft pegs have retained their appeal. In view of this, the final section revisits the corners hypothesis and offers an alternative policy perspective for emerging market economies.

## 2. The Problems with Super-Fixes

An underlying weakness with adjustable peg regimes is in a sense exactly that the peg *is* adjustable. A problem occurs when foreign currency markets see the adjustment coming. Speculators face the infamous one-way option and act accordingly. There will be a period of time when governmental commitments to maintaining the peg lack credibility. But how can an exchange rate peg be made credible? Only by making it almost unshiftable, i.e. a “hard peg” or “super fix”. This might be done by maintaining one’s national currency but creating a rigid commitment to permanently fixed or “hard” rates, through institutional arrangements such as a currency board arrangement, or by effectively abandoning the domestic currency altogether by using domestically the currency of another country (dollarization, yenization or eurorization). However, as will be discussed briefly below, each of these superfixes has its own problems which may make it an unattractive or unviable policy alternative.

### 2.1 Currency Boards

The durability of the Hong Kong and Argentine currency boards in the face of acute speculative pressures in the 1990s appears to have initially convinced some observers of the virtues of such a regime for a number of emerging economies. Nevertheless, it is generally recognized that a currency board arrangement requires the satisfaction of a number of preconditions, including a strong and durable domestic financial system that is able to withstand possible interest rate hikes on a sustained basis at times when the domestic currency is under selling pressure (Frankel, 1999). Failing this, currency crisis vulnerability might merely be transformed to financial sector vulnerability. To the extent that the banking systems in many emerging economies remain weak, the currency board arrangement alternative appears to be infeasible over the near and medium-terms. This is especially so since the lender of last resort function of a central bank is eliminated by the introduction of a currency board, in turn implying the need for a strong, well-capitalized and well-supervised domestic financial system to be in place<sup>1</sup>. There is also the question of whether such economies have the degree of labor market and internal flexibility - as in the case of Hong Kong, for instance - to make such a super fix viable. Failing this, a currency board arrangement makes adjustments to large economic shocks extremely costly. In such circumstances, forsaking the exchange rate as a policy tool is not an appealing option.

In addition, it is revealing that both Hong Kong and Argentina themselves have, in recent times, been enthusiastic proponents of exploring moves towards alternative hard peg arrangements by their respective

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<sup>1</sup> The point is sometimes made that the preconditions are not necessary for the implementation of a currency board or dollarization (which overlap considerably). No doubt that dollarization or currency board arrangements can be implemented prior to reforms. But the key question is, what are the implications of doing so? Eichengreen (2001a) provides a useful discussion of this issue.

regions -- dollarization in the case of Latin America and East Asian monetary cooperation or at least coordination in the case of Hong Kong. Cynics of currency board arrangements have interpreted this as the two economies looking for viable exit strategies from their respective currency boards arrangements. The Argentinean case is especially revealing. While Argentina's hard US dollar peg was important in helping the country realize financial and monetary stability, the recent large shocks in emerging market economies (Mexico in 1994-95, East Asia 1997-98 and Brazil in 1999) required exchange rate adjustments that were not forthcoming. This in turn necessitated extremely painful internal adjustments; the currency board arrangement had become a severe liability. Argentina's concerns with and seeming lack of commitment to its US dollar based currency board arrangement was made apparent following the approval of a Senate bill in Argentina which agreed to broaden the peg to a combination of euro and US dollar once the two are on par, along with the introduction of a *de facto* dual exchange rate regime (for exporters and importers) (Catan, 2001).

## 2.2 Dollarization

In view of the limitations of the extremes of flexible and currency board arrangements, some observers have reached the conclusion that a single currency zone may be the most attractive option for small and open economies. This entails an entire region adopting another country's currency (like the US dollar) as its own or establishing an entirely new one. Prominent economists have urged emerging economies in Latin America to form a monetary union with the US, or more specifically, they ought to abandon their respective national currencies in favour of the US dollar (Hausmann, 1999). Some like Ecuador and Panama have already done so. While such a policy may have some merit in Latin America (though sceptics do abound even in this case), the relatively low levels of *de facto* dollarization in other regions like Asia (compared with Latin America) makes dollarization an unfeasible option. The same argument holds against policies of

euroization or yenization<sup>2</sup>. In any case, regardless of the economic arguments, very few countries appear willing to unilaterally abandon the domestic currency for that of another country; this could be viewed as giving up some degree of political independence and sovereignty.

Among the choice of superfixes, the political unpalatability of dollarization, along with the above-noted policy constrictions of a currency board, seems to leave only a common regional currency as a practicable alternative. Is it? Eichengreen (1994, pp.4-7) appears to think so. He has predicted that, in the future, capital mobility will leave countries with one of two choices -- a super fix involving monetary union or the other extreme of floating.

## 2.3 Monetary Union

Having experienced the turbulence of financial crises in the 1990s against the backdrop of the successful introduction of a single European currency, there has been much popular discussion about the economic and political feasibility and desirability of forming regional common currencies in Asia and Latin America, akin to the European Monetary Union (EMU). From a solely economic perspective, the viability of a monetary union involves comparing the benefits of microeconomic efficiency (lower transactions and information costs, reduced bilateral exchange rate uncertainty, and such), on the one hand, and the costs of forsaking macroeconomic flexibility, on the other. Nonetheless, the European experience has emphasized the need for strong political will and consensus towards such a policy goal; the

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<sup>2</sup> The relative merits of dollarization over a currency board are not discussed here (see Frankel, 1999). Suffice it to note that the major advantage of dollarization is a reduction in currency (and possibly even country) risk premium, therefore offering lower domestic interest rates, as well as elimination of concerns regarding the sustainability of the domestic currency peg (i.e. no "escape clause"). The most important disadvantage of moving from a currency board arrangement to dollarization is the loss of seigniorage, constraints on liquidity management, as well as the transition costs.

anxiety of another war probably hastened the moves towards European integration. Indeed, some dispute the relevance of economic criteria altogether, claiming that, as with dollarization, political considerations dominate the formation of currency areas (for instance, see Goodhart, 1995). Apart from this strong political commitment, solving the problems of governance and accountability needed to form a regional currency union may be far too herculean a task for most other groups of countries outside Europe in the foreseeable future (Kenen, 2000).

### 3. The Flexible Exchange Rate Option Reconsidered

#### 3.1 Reasons to Favor Flexibility

A priori, there are a number of reasons that underlie a preference for a greater degree of exchange rate flexibility.

First, the greater the degree of flexibility of the exchange rate regime, the keener the incentives for agents to undertake appropriate forex risk management techniques in response to the higher element of exchange rate risk, while simultaneously reducing the extent of moral hazard which could lead to “excessive” unhedged external borrowing (referred to as a “fixed exchange rate bubble”). The introduction of these transactions costs and exchange rate risks may also help moderate the extent of capital inflows, consequently dampening the intensity of boom and bust cycles (this is essentially a moral hazard argument).

Second, banks tend to dominate the financial systems in the region, and the credit transmission channel plays a significant role in these countries. Calvo (1999) has shown that, *ceteris paribus*, the operation of this credit channel (which affects the IS curve directly and acts as a real shock) could tilt the balance in favour of greater exchange rate flexibility.

Third, small and open economies are far more susceptible to large external shocks, such as changes in foreign interest rates, terms of trade, regional contagion effects and the like. Received theory tells us that a greater degree of exchange rate

flexibility is called for in the presence of external or domestic real shocks. By acting as a safety valve, flexible exchange rates provide a less costly adjustment mechanism by which relative prices can be altered in response to such shocks, as opposed to a fixed rate. The latter relies on gradual reductions in relative costs via deflation and productivity increases vis-à-vis trade partners to restore internal balance. This can prove to be prolonged and costly as the Argentinean example above illustrates<sup>3</sup>.

Fourth, many small economies have diversified trade structures (dependent on the US, Japan, Europe and intra-Asian trade). Optimum Currency Area (OCA) criteria suggest that such economies are good candidates to maintain more flexible regimes. Thus, in the case of East Asia, institutionalization of the pre-crisis dollar pegs (via a currency board or dollarization) would not have helped domestic economic performance in 1996-97 (just prior to the crisis) to the extent that the problem was, at least partly, one of loss of competitiveness due to fluctuations in the US dollar and yen cross-rate (as noted in section 1). Consistent with this, a recent study of exports by about 100 emerging economies to the US, Japan and Europe over the period 1983-92 concludes that the more flexible the exchange rate regime the better the export performance (Nilsson and Nilsson, 2000). However, countries pegging to a composite group of currencies do not appear to have weaker

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<sup>3</sup> Three points should be noted here. One, empirical evidence suggests that pass through of devaluation is partial; indeed, inflationary predictions were dire in many economies following the financial crises in the 1990s but did not materialize. Two, devaluation can have real effects in the short-term during non-crisis periods. Devaluation during crisis periods appears to be *contractionary* rather than *expansionary* (Hausmann et al., 2000 and Rajan and Shen, 2001). Three, repeated devaluations will only have price effects without any real effects as they come to be anticipated by the private sector.

economic performance than countries with independently floating regimes<sup>4</sup>.

Fifth, it is often suggested that a rigid basket peg may operate as a nominal anchor for monetary policy and be a way of introducing some degree of financial discipline domestically and breaking inflationary inertia (Bird and Rajan, 2000). Thus, a multi-country study of 136 countries over the period 1960-89 conducted by Ghosh et al. (1996) found that inflation rates generally tend to be greater and more volatile under more flexible regimes, though economic growth is less volatile. An IMF (1997) study of 123 emerging economies covering the period 1975-96 arrives at a broadly similar conclusion, viz. the median inflation rate of “peggers” has been consistently lower and less volatile than those with more flexible arrangements, though the inflation rate differential between the two sets of countries has decreased through the 1990s<sup>5</sup>. However, Glick et al. (1999) have argued that policies of pegging exchange rates in East Asia were of little benefit in terms of acting as a counter-inflationary device, this goal having been attained primarily due to other factors such as relative autonomy of the monetary authorities. In their view, the use of exchange rates as nominal anchors may have actually acted as a liability as it prevented the necessary adjustments in response to external shocks. In addition, both theory and lessons of experience with nominal anchors have shown that such pegging loses credibility over time and induces booms followed by inevitable busts and crises episodes (Bird and Rajan, 2000). Pegging the exchange rate also constrains monetary independence<sup>6</sup>. If

<sup>4</sup> Their data is based on official IMF classification of exchange rate arrangements, i.e. they use *de jure* rather than *de facto* exchange rate regime.

<sup>5</sup> While these studies are instructive, they are no means conclusive as they do not account for the possibility of endogeneity of the choice exchange rate regimes. Specifically, we cannot be sure as to whether a fixed exchange rate actually leads to lower inflation or whether countries, which experience low inflation rates adopt such a regime.

<sup>6</sup> Conversely, if unrestrained monetary policy has been a facet of the country's past,

monetary and fiscal policies have proved effective in the past, governments may be reluctant to constrain their ability to use them in the future by targeting a particular exchange rate. The choice therefore depends on the relative merits of alternative macroeconomic policy instruments.

Sixth, there is a widespread belief that a pegged regime induces increased policy discipline as fiscal profligacy will lead to reserve depletion or burgeoning debt and an eventual currency collapse. However, the effects of unsound macro policies become evident immediately under flexible rates through exchange rate and price level movements (i.e. depreciation-inflation spiral). Thus, flexible rates ought to instill greater fiscal restraint/discipline as the costs of macroeconomic policy transgressions have to be paid upfront. In other words, the key distinction between fixed and floating rates is in the intertemporal distribution of costs and benefits (Tornell and Velasco, 2000). Gavin and Perotti (1997) have provided some empirical validity of this argument. After controlling for a host of other factors, they find that Latin American fiscal policies were more prudent under flexible rates than under floating ones.

### 3.2 Reasons for a “Fear of Floating”

In view of the anticipated benefits of flexible regimes, the IMF has advocated this type of regime for a number of emerging economies.

Despite the preceding reasons favouring a flexible exchange rate regime, countries with flexible regimes have experienced “excessive” volatility over the last few decades<sup>7</sup>. It is admittedly difficult to

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imposing exchange rate fixity may be an advantage as it constrains the active use of monetary policy. However recent empirical evidence casts doubt on the extent to which floating regimes in emerging economies provides insulation from foreign interest rate shocks (see Frankel et al., 2000 and Hausmann et al., 1999).

<sup>7</sup> Of course, almost no country has maintained a completely free (or pure) float, the authorities intervening intermittently to smooth market fluctuations. In other words “dirty floats” - i.e. forex market

define what exactly is meant by the term “excessive”. However, a reading of the relevant empirical literature reveals that evidence of excessive exchange rate variability comes in a number of forms (Bird and Rajan, 2001). For instance, a number of surveys of foreign exchange (forex) market participants clearly indicate that short-term/high-frequency exchange rate movements are caused by “speculative” or “trend-following” elements rather than underlying macroeconomic fundamentals. The problem of destabilizing speculation (as opposed to the Friedmanite speculators) and consequent excessive or self-aggravating exchange rate volatility and dominance of fads and bubbles, appears to be aggravated in emerging economies, making a flexible regime especially unviable/unsuitable to them. This is particularly so since thin markets, which exist in emerging economies imply that a few transactions can lead to extreme exchange rate fluctuations.

Even if it were accepted that flexible exchange rates often appear to exhibit greater volatility in high frequency data than would be warranted by the underlying fundamentals, why might such excessive volatility be of concern? Recent studies have provided evidence of a negative impact of exchange rate volatility/uncertainty on investment (Corbo and Cox, 1995 and Huizinga, 1994). To the extent that investment has a significant positive impact on economic growth, declining investment will have an enduring adverse effect on the quantity of real resources. Even in the absence of a negative effect on the level of investment, exchange rate variability may have an adverse influence over the composition of investment since decisions could be based on disequilibrium prices. In an important study, Bénassy-Quéré et al. (1999) show that exchange rate volatility could have a detrimental impact on FDI, comparable to the distortions created by currency misalignments.

It has often been argued that firms and other agents involved in international

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interventions without commitment to defend any specific parity - have been the norm. The US dollar probably comes closest to being a free float.

transactions can undertake hedging operations to shield themselves against exchange rate movements. However, apart from the costs involved with such operations, perfect hedges may be very difficult to create technically (given acute revenue-cost uncertainties) (Adler, 1994). Indeed, even if they could be created, they would entail non-negligible transaction costs, thus diverting scarce resources from “real” economic activity. This is especially true in the case of emerging economies where rudimentary capital markets have necessitated using cross-hedging techniques (rather than direct hedging), which invariably are far costlier.

Wei (1999) provides some important empirical evidence which suggests that exchange rate volatility has had a detrimental effect on trade between pairs of countries to a much larger extent than suggested by previous studies. More generally, in a comprehensive survey of the literature on the impact of exchange rate volatility on trade flows, McKenzie (1999) concludes that the recent empirical studies have had “greater success in deriving a statistically significant relationship between volatility and trade” (p.100). Calvo and Reinhart (2000) review a more limited set of such studies and draw a similar conclusion. Another recent set of empirics by Andrew Rose based on gravity models using both cross-sectional and time series data suggests institutionally fixed exchange regimes (i.e. common currency, currency boards or dollarization) stimulates trade, which in turn boosts income (see Frankel and Rose, 2000, Glick and Rose, 2001 and Rose, 2000). As is common knowledge, proponents of the European Monetary Union (EMU) have used such an argument extensively in support of a single regional currency<sup>8</sup>.

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<sup>8</sup> Conversely, as regional countries become increasingly integrated through trade and investment, arbitrary shifts in comparative advantage and demand due to alterations in exchange rates may provoke political backlash and disrupt real intra-regional linkages. In addition, a regional currency eliminates transaction and information costs (i.e. enhances transparency) and reduces the likelihood that producers can arbitrarily price discriminate across countries in the region. This problem becomes especially

Notwithstanding the recent weakness of the Australian dollar, its successful experience with a floating arrangement, particularly in terms of withstanding the East Asian crisis, has often been cited as evidence of the “superiority” of such a regime, and has been prescribed as a panacea for other emerging economies. However, such an advocacy does not pay due consideration to the fact that there are important structural differences between industrial countries such as Australia, on the one hand, and emerging economies, on the other. For instance, industrial countries have well-developed and diversified financial systems that are able to minimize real sector disruptions due to transitory exchange rate variations (abstracting from the resource allocation costs of misalignments noted previously). Most importantly, industrial countries are able to borrow overseas in their domestic currencies. Many emerging economies are unable to do so, leading to an accumulation of foreign currency debt liabilities that are primarily dollar denominated and unhedged (i.e. “liability dollarization”)<sup>9</sup>. In such countries, sharp depreciations in their currencies alter the domestic currency value of their external debt and therefore the net worth of the economies, with calamitous real sector effects (so-called “balance sheet” effects). This in turn may be an explanation for the continued priority given to a high degree of exchange rate stability in emerging economies. In other words, they are plagued by an acute “fear of floating” (Calvo and Reinhart, 2001).

#### 4. Concluding Remarks

The so-termed “hollowing out hypothesis” or “law of the excluded middle” appeared to draw analytical support from the “Impossible Trinity or Trinity”. Simply

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acute when regional countries have agreed on a trade pact – why bother negotiating detailed tariff and rules of origin requirements when sudden currency depreciation by a member alters relative prices and competitiveness, offsetting the effects of the regional trade rules that were agreed upon?

<sup>9</sup> This is commonly referred to as the “original sin” hypothesis, a term attributed to Hausmann (1999) and Hausmann et al. (2000).

put, this states that a country cannot simultaneously conduct independent monetary policy and pursue a fixed exchange rate if it wants to remain completely open to international capital flows (Figure 1 again). From an analytical perspective, Frankel (1999) has provided us with the timely reminder that the Impossible Trinity or Trilogy does not on its own imply that in an increasingly globalized world economy an intermediate regime is unviable or that countries will be compelled to abandon the middle ground. In fact there is a growing body of opinion that recognizes the potential usefulness of restraints on financial flows as a financial safeguard; there is no longer an ideological belief in the benefits of a completely open capital and financial account<sup>10</sup>. Once this is accepted, the analytical basis in support of the corners hypothesis weakens substantially; neither corner appears to work all that well for emerging economies. Consistent with all this, it is useful to note the recent response to a question of the current and appropriate exchange rate for Thailand by the country’s finance minister, Pridiyathorn Devakula

‘(W)e are using the stabilized exchange rate as one of the guiding principles. Why do we have to use this? It’s simple - there are two extreme: fixed exchange rate and clean float...(M)y attitude to fixed exchange rates - don’t do it. If you do, you invite trouble and finally lose all your reserves. The other is clean float. If we were strong like the U.S., Japan, Germany we would go clean float. Because a clean float rate can swing to extremes, it can savage our current account. When the economy is weakening and confidence of private businessmen is not that high, we must make sure our currency does not swing to the extreme where it creates panic. That’s why we have to choose the middle road.’ (Far Eastern

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<sup>10</sup> While empirical evidence regarding the benefits from capital account liberalization is unclear, risks of premature and ill-timed liberalization are unequivocal (Arteta, 2001).

Economic Review, July 26, 2001, pp.50-1).

The preceding leads to the rather unsatisfying conclusion that when it comes to the choice of appropriate exchange rate regime, all that can really be said is that there exists a broad spectrum of choices. It is not a black-or-white issue; shades of gray abound. The choice of exchange rate regime cannot be done in isolation. It must be seen as part of a coherent macroeconomic strategy. No exchange rate regime will deliver stability if domestic macroeconomic policy is unsound, with large fiscal deficits, rapid monetary growth and inflation. Pegged exchange rates will become overvalued and reserves will fall, while flexible exchange rates will depreciate and may result in crises just as much as pegged regimes. Exchange rate policy in emerging economies may need to have a more limited objective. Rather than focusing on disciplining domestic macroeconomic policy and labor markets, perhaps the exchange rate regime should be designed in the first instance to minimize exposure to the third currency phenomenon, where the problem for emerging economies arises from fluctuations in the values of the currencies of their major trading partners against each other.

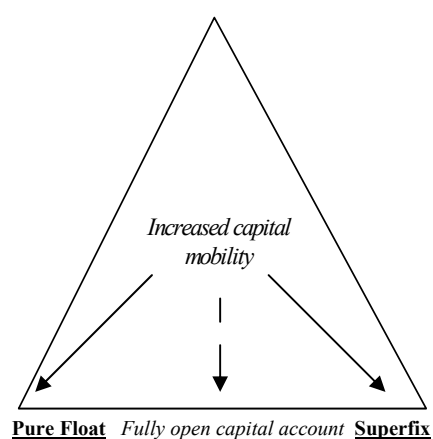
In the absence of strong capital controls, currency intervention ought *not* be framed as a specific target for the exchange rate. Such targets inevitably tempt speculators by offering them the infamous one-way option. Thus, exchange rate and monetary policy strategies must involve a “fairly high” element of flexibility rather than a single-minded defense of a particular rate. This might best be achieved by a variant on sliding parities and wider bands around an appropriately weighted currency basket, the extent of which varying across the countries depending on individual circumstances and policy preferences (a so-termed band-basket-or-crawl or BBC)<sup>11</sup>, or a flexible inflation target. The latter involves gradual adjustment to an inflation target along with a positive weight on the exchange rate (in addition

<sup>11</sup> The crawl is meant to compensate for inflation differentials. Williamson (1999) discusses the BBC policy in some detail.

to inflation and output)<sup>12</sup>. While an outstanding research issue is to what extent the technical requirements and policy implications of BBC regime (involving targeting of the real or nominal effective rate) differs from a policy of flexible inflation targeting, importantly, neither policy supports the benign neglect of the exchange rate.

**Figure 1:**

*The Impossible Trinity*  
Closed Capital Account



Source: Author based on Frankel (1999)

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<sup>12</sup> Many central banks that purport to operate an inflation target, actually pursue a flexible one. This is clear by the fact that in most cases the official monetary policy stance is captured by a “Monetary Conditions Index” or MCI which is a weighted average of the interest rate and the exchange rate. Eichengreen (2001b) discusses definitions and issues surrounding a monetary policy strategy organized around an inflation target in some depth.



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***NEW feature for the BNE!***

*From time to time the BNE will provide a preview of a full Book Review (to be published in a future issue) with a much shorter Book Note. The first of these Book Notes appears below.*

**Book Note:**

**Globalization and its Discontents**, by Nobel Prize for Economics winner **Joseph Stiglitz**, is a wide-ranging critique of the International Monetary Fund and its policies during the 1990's. Stiglitz served

on the Council of Economic Advisers under Bill Clinton, and then as Chief Economist and Senior Vice President of the World Bank for three years, therefore offering us a credible inside perspective into the workings of the Bretton Woods institutions in general and the IMF in particular. In his view, the IMF which he asserts is strongly influenced by the U.S Treasury, has adopted an ideology of Market Fundamentalism, which serves the interests of the world financial markets rather than those of the global community at large. In a case study on the role of the Fund in the East Asia crisis, and Russia's transition to a market economy, Stiglitz outlines the failings of IMF policy and their dogmatic approach to economic policy. He calls for the Fund to go back to monetary crisis prevention, and urges for a shift in priorities towards economic fundamentals affecting residents of developing countries.

*Alieu Senghore*

**Book Review:**

*Robb, Caroline, M. (2001). Can the Poor Influence Policy? Participatory Poverty Assessments in the Developing World. World Bank Publications: Washington, D.C. PP 195. ISBN 0-821-35000-5.*

Participation of the poor has now been recognized as a necessary condition for a successful development project in fighting poverty. Participation is no longer a new concept to any donor agencies, or to multi-lateral development banks whose ideas have been traditionally receptive to participatory approaches. Robb clearly points out the changes that are now happening among the Bretton Woods institutions: the World Bank and the IMF. Robb describes in details how the Bretton Woods institutions are transforming their operations to apply Participatory Poverty Assessment (PPA) approaches and see the use of PPAs as effective in meeting the needs of the poor.

Chapter 1 introduces PPAs definition and principal methods such as beneficiaries' assessment (BA), rapid rural appraisals (RRA), poverty monitoring and evaluation (PME). The chapter also touches upon a long-disputed issue (on whether the

conduct of a PPA should come before household surveys or the other way around) and looks at their pros and cons.

Chapter 2 looks into the impact of PPAs on development policy formulation processes and policy itself. The discussion draws attention to three important questions: (1) Can PPAs help us to understand the poor? (2) Can PPAs help to change attitudes of policy makers?, and (3) Can PPAs help to strengthen policy formulation processes? The book describes how attitudinal changes happened among the staff of the World Bank and the government officials in developing countries. It gives analysis on the determinants of the levels of PPAs' impact on policy formulation and implementation. Chapter 3 presents good practices and lessons learned from the cases where PPAs were applied in its project design and policy formulation. It explains impact variables, such as management and teamwork factors in the World Bank, PPA ownership of the government, dissemination efforts by the government, PPA skills, etc. The cases illustrate how these factors shape the nature of policy to be made. The last chapter discusses the link between Poverty Reduction Strategies for the Poor (PRSPs) and PPAs.

This book raises several critical, and some would say controversial, issues in connection with initiatives that involve the poor in influencing the policy formulation processes. First, the ownership of PPA needs to stay with the government, not with donors funding PPAs, and that the ownership is the key factor in sustaining development activities in the long run. PPAs can make policy more responsive and accountable to the poor. Second, the linkage between qualitative (PPA) and quantitative (household surveys) data is succinctly discussed in detail. In particular, the book provides a good summary on some of the limitations of PPAs and emphasizes the point that PPAs complement household surveys. Third, the book points out that there are institutional obstacles that inhibit the effective use of PPAs in development work. These obstacles include absorbing capacity and managerial immaturity that impair the efficiencies of the PPA to be conducted. It stresses that the World Bank is now

moving to undertake poverty analysis on a regular basis, as opposed to the traditional ad-hoc one-time poverty assessment, and recognizes the importance of the qualitative information obtained from the poor in its policy formation. (p.47)

Some problems however are found in Robb's arguments and analysis. For example, the statistical analysis in Chapter 2 should explain more about its model, especially in its weighting used in the CCI analysis to differentiate the levels of impact on policy. The book talks about PPA as if they are the only proven tools available to reflect the poor's perspective into the formation of policy. Rather, what the development practitioners need to do is to examine which methods, including both PPAs and others, are most effective in helping the poor shape development policy. The use of PPA does not necessarily mean that the voices of the poor are heard and included in policy making. True, their inputs can be used but they are not strong enough as binding forces that the government agencies have to comply with. The governments can choose policy with no consideration or without making efforts in including the inputs from the poor. Furthermore, there is virtually no discussion of governance issues: this is a must without which PPA mechanisms will fail to take off.

Participatory approaches are indeed cross-cutting issues in poverty reduction and governance. PPAs could help us to understand the poor well and come up with better solutions or ideas to help them get out of poverty. The good governance is contingent to efficient policy implementation. Governance factors should be considered as major determining factors for poverty reduction if we aim at reaching out to the poor and encourage them to voice out their development needs.

In all, Robb has made a good summary of recent institutional transformation that the World Bank has undergone with PPAs. It is, however, not a comprehensive study on participatory development and fails in important ways in keeping the poor as the centre of policy making.

**Takayoshi Kusago**

### Forthcoming Conferences:

**February 20-22, 2004:** The annual meetings of the Eastern Economic Association will be held in Washington, D.C., USA. Further information available from the conference organiser Dr Mary Lesser who may be reached by e-mail at [mlesser@iona.edu](mailto:mlesser@iona.edu) and via the conference website at [www.iona.edu/eea/](http://www.iona.edu/eea/)

**March 30 – April 1, 2004:** The annual conference of the Scottish Economic Society will be held in Perth, Scotland. Papers in all areas of economics and econometrics are welcome. Further information may be found at [www.scotecsoc.org](http://www.scotecsoc.org)

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