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The Choice of Exchange Rate Regimes: Where Do We Stand?¹

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“Exchange rate regimes in emerging markets have been a primary concern of international economists and policy makers since the 1990s cycle of record capital flows to these countries followed by widespread crises.”

(Frankel and Wei, 2007)

“Mutual exchange rate stability is the quintessential public good. ... This point was well recognized by the designers of the old Bretton Woods parity regime in 1944, but their successors ... act as if they have become oblivious to it.”

(McKinnon, 2005)

1. Introduction

Widely neglected in everyday life, but – more important – in day to-day economic policy making the choice of a country’s exchange rate regime is one of the most important framework decisions for economic development. Eventually, this decision affects most if not all fundamental structures as well as the design of the entire economy, starting from the functioning of the price system to market structures via many channels in different ways. Mainly for this reason, the creation of a new International Monetary System was the main focus of the political discussions shaping the new international economic order after the Second World War. Nowadays, the EUR/USD exchange rate as well as the exchange rate policy of China are at the heart of international economic policy discussions.

However, in stark contrast to this the fundamental importance of the exchange rate regime chosen and its implications become visible to the public audience and/or to domestic economic policy makers only from time to time. An exchange rate crises obviously is the most certain occasion. Economic integration, a process shaping not only the European situation but in place globally, is another important process closely linked to exchange rate developments and, in particular, the

¹ The title of this paper makes a special reference to the late Rudi Dornbusch (1980), who contributed a lot to our modern understanding of exchange rate economics.

influence of the exchange rate regime on macroeconomic variables and related economic policies. Therefore a look at the ongoing and forthcoming integration process of Central, Eastern and Southeastern European Countries (CESEE) with the European Union and, eventually, European Monetary Union from the perspective of exchange rate regimes is one of the obvious starting points for this. This includes also the analysis of the exchange rate history of this European region as the institutional perspective of exchange rate regimes is one of the most persistent economic arrangements shaping the structure of a country for decades.

There is extended economic literature covering all types of questions related to exchange rate regimes from the times of the Gold Standard up to today's liberalized international financial market conditions from various perspectives. However, the conclusions from the available theoretical as well as empirical literature on the topic seem far from clearcut. This can be illustrated by a short but significant collection of statements from the recent literature:

- The choice of exchange rate arrangements that countries face at the beginning of the twenty first century is considerably greater and more complicated than they faced at the beginning of the twentieth century yet the basic underlying issues haven't changed radically. (Bordo, 2004).
- The choice of exchange rate regime is a subject that attracts strong opinions, often based on weak theory. (Crockett, 2003)
- Each of the major international capital market-related crises since 1994 has in some way involved a fixed or pegged exchange rate regime. At the same time, countries that did not have pegged rates avoided crises of the type that afflicted emerging market countries with pegged rates (Fisher, 2001).
- No exchange rate regime is likely to serve all countries at all times. (Gosh et al., 1997).
- Countries choose their exchange rate regime for a variety of reasons, some of which have little to do with economic considerations. However, if the choice of exchange rate regime is to have any rational economic basis, then a first requirement must surely be to understand the properties of alternative regimes. (Gosh et al., 2002).

Taken together, this selection of quotes – although far from being able to cover the extensive literature on exchange rate regimes in any respect – very well illustrates the difficulties economic policy faces in drawing any convincing solutions from the literature as well as the challenging nature of the entire subject.

Nevertheless, few questions in international economics have aroused more debate than the choice of an exchange rate regime. Should a country fix the exchange rate or allow it to float? And if pegged, to a single “hard” currency or a basket of currencies? Economic literature pullulates with models, theories, and propositions. Yet, little consensus has emerged on how exchange rate regimes affect common macroeconomic targets, such as inflation and growth. At a theoretical level, it is difficult to establish unambiguous relationships because of

the many ways in which exchange rates can influence – and be influenced by – other macroeconomic variables. Likewise, empirical studies typically find no clear link between the exchange rate regime and macroeconomic performance.

Ultimately, the exchange rate regime is but one facet of a country's overall macroeconomic policy. No regime is likely to serve all countries at all times (Gosh, 1997). Countries facing disinflation may find pegging the exchange rate an important tool. But where growth has been sluggish, and real exchange rate misalignments common, a more flexible regime might be called for. The choice, like the trade-off, is the country's own.

Starting from this, the paper covers a range of current issues related to the choice of the exchange rate regime in a rather condensed way to set the general scene for the much more specialized contributions to follow. First, it gives a short history of the International Monetary System to derive from this, second, some stylized facts concerning the nature of exchange rate regimes and, third, dealing with the essential factors shaping the choice of the exchange rate regime. Fourth, a quick overview of prevailing exchange rate regimes in CESEE countries is presented to review, finally, the recent challenges of these countries in joining the European Union, ERMII and, in the end, the single monetary policy and the euro. No need to mention that the attempt to cover all these issues in one short paper is an impossible exercise. However, leaving many things aside, the objective of the paper is to provide a quick orientation regarding the most important aspects to guide the reader through the subject of the following papers.

2. As a Starting Point: An Extremely Short History of the International Monetary System and Exchange Rate Regimes

Much of the changes and the progress of international monetary systems reflect concerns with particular recurring historical puzzles. A familiarity with the broad strokes of monetary history hence often comes in rather useful in understanding where the field has come from and where it is heading.

During the late 19th century and the early days of the 20th century, exchange rate regimes were dominated by fixed exchange rate regimes until the breakout of the First World War. In those days, the classical gold standard constituted the building block of the international monetary system. The classical gold standard may not be the beginning of exchange rate history, but it is a convenient starting point for considering the evolution of conventional wisdom on the subject. For several decades around the end of the 19th century, the gold standard functioned with apparent success (Crockett, 1997). Under the classical gold standard, the rate of exchange of the different currencies was given by the mint parity, i.e. the rate of exchange of the domestic currency vis-à-vis the price of gold related to the rate of

exchange of the foreign currency against the price of gold. Because governments credibly committed themselves to the fixed gold price and because of the free flow of gold across countries, private sector agents started gold arbitrage as soon as market prices departed from the official price. Consequently, fluctuations around the mint parity were actually delimited by the cost related to transporting gold from one country to another, like freight, insurance, handling (package and cartage), interest on money committed to the transaction and risk premium (Officer, 2001).

The eruption of the First World War in August 1914 led to the dissolution of the classical gold standard chiefly due to a run on the sterling. By that time, the reserve ratio in Britain, which is the ratio between gold reserves and liabilities to foreign governments (foreign sterling reserves) was extremely low. In this situation, the Bank of England decided to impose exchange rate controls, which led to the breakdown of the system. With the end of the war, most countries sought to re-establish exchange rate stability and returned, one after another, to a (sort of new) gold standard rule by the mid-1920s – only to give up gold again after the onset of the Great Depression in the early 1930s (Eichengreen, 1989). The gold standard that apparently worked so well in the pre-First World War periods did not prevent chaos and depression in the 1920s and 1930s. What triggered this change? The short-lived interwar gold standard differed from the classical coin gold standard as it was a bullion gold standard or a gold exchange standard, in which a country's currency was backed by a reserve currency exchangeable to gold. This mechanism became more and more complicated as the US dollar developed to challenge the sterling as the dominant international reserve currency.

Another era of fixity came to be decided at the Bretton Woods conference in 1944 that lasted until 1973. The Bretton Woods conference represented the first successful attempt to consciously design an international economic system. It reflected lessons drawn from both the fixed and floating period. The floating rate period seemed to teach that exchange rates should be viewed as matters of mutual concern, since individually determined exchange rate policies could be inconsistent and unstable (McKinnon, 2005). The gold standard experience seemed to show that fixed exchange rates were more stable, but required a credible domestic adjustment mechanism, a cooperative international environment, and an absence of destabilising capital flows. The Bretton Woods system worked well as long as capital flows were modest, international inflationary and deflationary pressures were limited, and countries accepted an obligation to direct domestic macroeconomic policies towards achieving external balance (Crockett, 1997).

The system was designed to provide fixed exchange rates fluctuating not more than $\pm 1\%$ around the central parity of the participating countries against the US dollar that served as the reserve currency and was tied to gold at a rate of USD 35 an ounce. This gold exchange standard worked smoothly until the USA started having large current account deficits financed by US dollar supply, in particular related to the financing of the Vietnam War. This meant that the other central

banks had to buy US dollar to maintain the fixed parity and thus accumulated large US dollar reserves. At a certain point, rumours about the FED's ability to convert those reserves into gold became more and more important. This resulted in the disconnection of the dollar from gold in 1971 and the float of the German mark against the dollar in 1973. This marks the beginning of a new era of floating, in which demand and supply on the market determined the relative price of two currencies and in which gold lost its former central monetary status and became a "simple commodity", at least from a monetary policy as well as an exchange rate regime perspective.

Table 1: Chronology of Exchange Rate Regimes

| | |
|--------------|--|
| 1880–1914 | Specie gold standard (bimetallism, silver), currency unions, currency boards, float |
| 1919–1945 | Gold exchange standard , floats, managed floats, currency unions (arrangements), pure floats, managed floats |
| 1946–1971 | Bretton Woods adjustable peg , floats (Canada), dual/multiple exchange rates |
| 1973–1998 | Free float, managed float, adjustable pegs, crawling pegs, basket pegs, target zones or bands, fixed exchange rates, currency boards; (<i>"snake" and ERM in Europe</i>) |
| 1999–present | European Monetary Union (<i>plus ERMII</i>), free float, managed float, adjustable pegs, crawling pegs, basket pegs, target zones or bands, fixed exchange rates, currency boards |

Source: Adapted from Bordo (2004).

In Europe, fears about the damaging effects of excessive exchange rate volatility prompted the creation of the so-called "snake" in which the European Economic Community (EEC) countries' currencies were tied one to another fluctuating in a tunnel against the dollar. The snake was superseded by the European Monetary System (EMS) in 1979 which paved the way for closer monetary ties in Europe. Monetary union, which had been proposed already earlier (Werner plan in 1970), came again on the agenda and was enshrined in the Maastricht Treaty in 1991. After turbulences in the EMS 1992/93 – which led to substantial devaluations of some currencies and related enormous swings in countries' competitiveness – the momentum to monetary integration was regained and led, eventually, to the launch of the euro in 1999.²

Eichengreen (1993), for example, indeed argues that the sequence of fixed to float and back again to fixed exchange rate regimes can be explained by (1) the presence or absence of a dominant power that takes the lead in securing fixed

² Triffin (1991) qualified the entire situation of turbulences and instability "...scandal?"

exchange rates, (2) the degree of international cooperation, (3) the intellectual consensus regarding the desirability of either systems, (4) macroeconomic volatility and (5) the coordination of fiscal and monetary policies.

3. The Nature of Exchange Rate Regimes

Notwithstanding the general view that the pre-1973 period was dominated by fixed and the post-1973 period by floating exchange rate regimes, a look at both developed and developing countries reveals substantial cross-country heterogeneity in this respect (Reinhard and Rogoff, 2002)³.

The wide range of observed exchange rate regimes begs the question whether large shifts occurred in the composition across fixed, intermediate and flexible exchange rate regimes over time. This is an interesting question, in particular in the light of the paradigms often aired in policy circles with regard to exchange rate regimes. The first paradigm, the so-called bipolar view, or the excluded middle in the words of Reinhart and Reinhart (2003), asserts that intermediate regimes are not sustainable and tend to disappear if capital flows are liberalised. The second paradigm, among others advocated by the IMF, emphasises the vulnerability of pegs to speculative attacks (the “crisis view”) and suggests a move from pegs towards more flexibility take place over time.

Looking at table 2 below indicates that a large number of countries had either a peg or a floating exchange rate in April 2006, and that only few countries opted for intermediate regimes. Chart 1 reveals that the two extremes (peg and float) are much more densely populated than the middle ground. This gives credit to the view that in practise countries seem to “need” to choose between fixity and flexibility. Nevertheless, pegs are more numerous than floating regimes, which is in contradiction with the second proposition related to the vulnerability of pegged regimes.

Although the nature of exchange rate regimes is rather difficult to characterise in practise, Eichengreen and Razo-Garcia (2006) – among other – show the decline of intermediary regimes since the early 1990s from about 70% to 45% in 2004. In particular, they conclude that among the advanced countries intermediate exchange rate regimes have almost disappeared. This tendency clearly supports the “bipolar view” related to a country’s degree of development and is reflecting monetary unification in Europe at the same time.

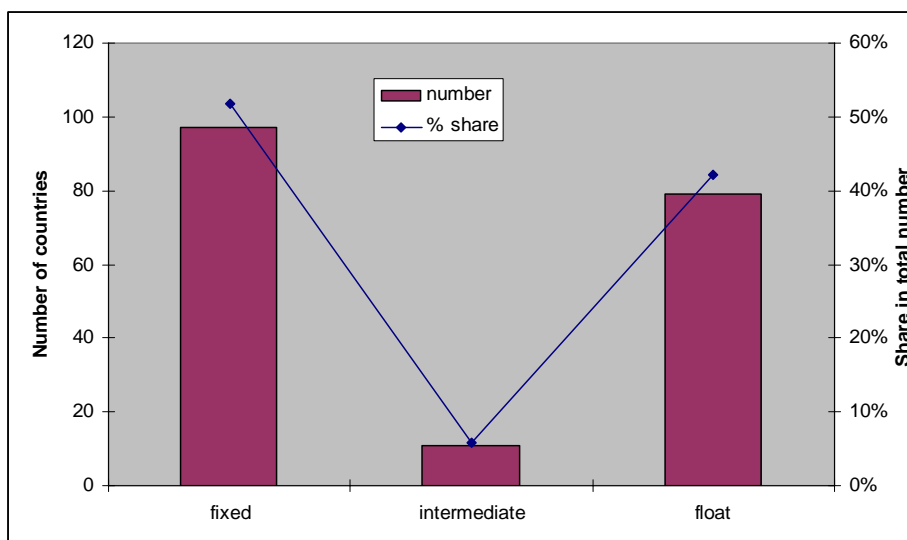
³ In fact, Reinhard and Rogoff (2002) argue that the move from Bretton Woods to float regimes did not have a major impact on the distribution of the different types of exchange rate regimes.

Table 2: De facto Exchange Rate Arrangements in IMF Member Countries, April 2006

| Exchange rate regime | Number of countries | % in total |
|--|---------------------|------------|
| 1. Exchange rate regimes with no separate legal tender | 41 | 21.9% |
| 2. Currency board | 7 | 3.7% |
| 3. Conventional pegs | 49 | 26.2% |
| 4. Pegs within horizontal bands | 6 | 3.2% |
| 5. Crawling pegs | 5 | 2.7% |
| 6. Crawling bands | 0 | 0.0% |
| 7. Managed floating | 53 | 28.3% |
| 8. Independent floating | 26 | 13.9% |

Source: IMF, *Annual Report on Exchange Rate Arrangements and Exchange Restrictions*, p. 3.

Chart 1: Distribution of Exchange Rate Regimes in April 2006



Source: Authors' calculations based on IMF, *Annual Report on Exchange Rate Arrangements and Exchange Restrictions*, p. 3.

While the main trends appear fairly clear, some caution is needed in interpreting them on the grounds that the distribution of exchange rate regimes might look differently for different country groups at different levels of economic development (developed, emerging and developing countries) and that there are various ways to determine the “genuine” (de facto) nature of a given exchange rate regime. As is

well known, the type of an exchange rate regime officially announced by the central bank or the government does not necessarily match with the actual behaviour of the exchange rate. The data shown in table 2 and chart 1 are based on the IMF classification of de facto exchange rate regimes,⁴ but alternative methods to determinate de facto regimes might well yield different outcomes.

A number of influential papers have scrutinized these issues. For instance, the analysis of Levy-Yeyati and Sturzenegger (2003) broadly confirms the U-shape in chart 1 in historical perspective from 1991 to 2000, though the share of intermediate regimes is higher and less floating regimes are identified with their classification algorithm from 1974 to 2000. However, and this came as a surprise, the picture changes when the distribution of regimes is looked at for different country groups. Indeed, for developed and emerging countries, intermediate regimes represented the largest share in 1991, while hard pegs, intermediate regimes and floats accounted for around one third each of the observations in 2000.

They assert that the number of de facto pegs remained fairly stable between 1991 and 2000 but the officially announced pegs recorded a dip. This phenomenon – “the hidden pegs” – can be observed for countries with liberalised capital accounts but not for countries with limited access to capital markets. Reinhart and Rogoff (2002) apply a different identification technique which looks at parallel exchange rate data for 153 countries starting from 1946 and come to even more straightforward results. They find that half of the officially announced pegs are not pegs, but rather a variant of float.⁵ Similarly, regimes that are officially labelled as float often turn out to be pegs in practice. On the basis of the Reinhart and Rogoff dataset, Husain, Mody and Rogoff (2004) undertake an even more scrupulous analysis of the data. Their results shed even more light on that issue. They show that pegs are very much long-lived in countries with limited access to capital markets, but are vulnerable in emerging markets, mainly due to sudden stops of capital flow. In addition to that, developed countries seem to be better off with floating exchange rate regimes than with pegs. Finally, they observe and predict an increasing trend towards intermediate regimes.

These results attest that the two paradigms lined out above – the bi-polar view and the supposed vulnerability of pegs – need to be taken with substantial qualification.

Calvo and Végh (2000) popularised the view that, as they coin it, “fear of floating” is one reason that explains why official floats resemble more to pegs in practice. They argue that fear of floating is a result of a lack of credibility of the

⁴ In fact, one has also to take into account that these classifications are based on questionnaires supplied by the respective IMF member countries and, therefore, represent a country’s view or philosophy concerning its exchange rate system.

⁵ A major criticism of Levy-Yeyati and Sturzenegger (2003) is that crisis periods, i.e. drastic devaluations or moves from one type of regime to another type of regime, are not eliminated from the dataset. Reinhart and Rogoff (2002) focuses on calm periods.

monetary authorities that results in volatile interest rates and sovereign credit ratings. They add that liability dollarization also incite central banks to seek to limit exchange rate volatility, because of the fear of large depreciations, also termed “dread of depreciation” by Dutta and Leon (2002), that could have disastrous balance sheet effects if there is a currency mismatch between assets and liabilities in the household and/or the corporate sector. Moreover, a higher degree of dollarization usually goes in tandem with higher exchange rate pass-through (Reinhart, Rogoff and Savastano, 2003). This being so, it is in the interest of the central bank to seek to reduce the impact of exchange rate fluctuations on the inflation rate.

Finally, it has to be stressed that a considerable change in how the role of exchange rate developments is qualified has taken place, which broadly influences the hierarchy and sequence of economic policy strategies to be followed. After the breakdown of the Bretton Woods system and under the impression of the difficulties the system faced during its final decade, exchange rate movements and exchange rate flexibility were mainly seen as important economic policy tools to address important macroeconomic imbalances successfully. This perspective is also a dominant ingredient of the famous Mundell-Fleming (OCA) approach of open economy macroeconomics, which attributes a rather strong position to the exchange rate as a policy instrument (Frankel and Rose, 1998).

Compared to this – optimistic – view of the exchange rate as a macroeconomic policy tool, the experience of the 1980s and 1990s led to a completely different assessment of exchange rate developments. In the wake of the European exchange rate crises of the early 1990s exchange rate developments were seen more and more as becoming a permanent source of international financial instability. To cope with this new understanding of exchange rates many initiatives were launched to create a new European framework of exchange rate stability. In the end, this change in perspective led to the establishment of the euro area as an institutional framework that makes exchange rate volatility obsolete as a potential source of macroeconomic instability.

Of course, in this new world our overall understanding of the role of exchange rates in economic policy was not the only thing to change; the hierarchy of economic objectives and policies has also changed substantially. In particular, for countries intending to join the European Union and – eventually – monetary union, stabilizing the exchange rate, via participation in ERM II first, has become an overriding goal in the integration and convergence process. This gives the exchange rate obviously a much higher weight in policy making even if countries are still at the beginning of the integration process.

4. The Choice of the Exchange Rate Regime

Standard theory suggests that the choice between fixed and floating exchange rate regimes should be governed by the desire to minimise output and employment volatility. Hence, the nature of the shocks hitting an economy is primordial. If an economy is exposed to nominal shocks due to money supply or demand, choosing a fixed exchange rate regime seems natural as it acts to absorb the nominal shock. If shocks are real, due to productivity for instance, a flexible exchange rate performs better.

However, standard theory is not very appealing to emerging market economies because “no exchange rate regime can prevent macroeconomic turbulence” (Calvo and Mishkin, 2003, p. 13). As a matter of fact, the choice of the exchange rate is of secondary importance in emerging market economies. What really matters is the quality of institutions, including fiscal, financial and monetary institutions. For instance, in a peg, irresponsible fiscal policy may lead to disaster if the peg breaks and the large depreciation realises existing balance sheet vulnerabilities due to liability dollarization. Nonetheless, float is not a remedy because it also allows large depreciations.

Notwithstanding these arguments, both types of exchange rate regimes have their merits and shortcomings. Generally, pegs are thought to be as a disciplining device for fiscal policy. At the same time, pegs reduce exchange rate premium that opens the way to financing public spending at cheaper rates, a possible recipe for disaster. Importantly, pegs may provide a usual nominal anchor to inflation expectations in the wake of high inflationary periods and even can import credibility of the anchor currency. Fixed exchange rate regimes help reaping the gains of economic integration by eliminating the detrimental effects of exchange rate fluctuations on trade (Frankel and Rose, 2002). Note that this argument contradicts the results of Husain, Mody and Rogoff (2004). Fixed exchange rates are more useful than floats for developed countries if they engage in economic integration and if adjustments due to asymmetric shocks can be adjusted by factor mobility, labour market flexibility or increasing intra-industry trade. Finally, keeping the exchange rate stable also promotes financial and macroeconomic stability if the share of foreign currency denominated private and public debt is high.

On the other hand, a floating exchange rate regime makes possible the conduct of an autonomous domestic monetary policy if capital flows are fully liberalised. Floats require no international reserves. Finally, large external imbalances that can build up easier under a peg if exchange rate misalignments become persistent can be handled not only via internal adjustment, as in a pegged regime, but also through the external adjustment channel (Calvo and Mishkin, 2003).

Obstfeld et al. (2004) forcefully restated the argument that policy makers in open economies face a macroeconomic trilemma of pursuing three typically

desirable, yet contradictory objectives. The trilemma consists of stabilizing the exchange rate, enjoying free international capital mobility and employing monetary policy for domestic goals at the same time. With liberalized international capital flows generally considered a basic precondition for participating in international markets, to fix or not to fix the exchange rate, and at which level of development to decide on the issue, become fundamental questions for a small country's policy orientation. Moreover, Obstfeld et al. conclude that based on empirical evidence the trilemma still makes sense as a guiding policy framework and that the constraints implied by it are largely borne out by history.

Relating this to the situation of countries at an earlier state of economic development or real convergence it becomes immediately clear that one of their permanent and ultimate policy-making objectives is to balance the needs between domestic development goals and international monetary integration.

5. Recent Exchange Rate Regime Trends in CESEE Countries

In an unstable environment and a situation in which it is difficult to establish internationally acknowledged institutions and to enforce sound decision-making, perhaps the biggest challenge for economic policy – and for monetary policy alike – is how to gain and preserve credibility. The preferred solution, anchoring the national currency somehow to a strong and stable neighbouring currency, is obvious. For Southeastern Europe (SEE) the euro is the obvious choice, given that trade figures indicate a close relationship between SEE and the euro area. Another advantage is that a stable exchange rate may enhance the already existing strong FDI between the two parties involved. Finally, this decision is based on the good experiences other small open economies have made with such kind of a strategy. Although the waters were much calmer then, one can refer to the hard currency policy of Austria in the 1970s and 1980s in this respect.⁶

At the beginning of transition and in the first half of the 1990s, many Southeastern European countries opted for managed or loosely managed floats, whereas the typical Central European and Baltic strategy was to anchor domestic currencies to the US dollar and/or the German mark, with increasing weight for the latter. A number of countries/territories (in the Western Balkans) that were not yet independent or had just become independent (Bosnia-Herzegovina, Kosovo, Montenegro and Serbia) remained dominated by the Yugoslav dinar up to the late 1990s or beyond. From the early years of that decade until the around the turn of the millennium most Southeastern European countries' currency regimes (except

⁶ For detailed analyses of the Austrian case related to the challenges of transition countries see Handler (1989) and Backe and Mooslechner (2004).

that of Albania) appeared to be steadily moving into the orbit or proximity of the euro. The same goes for Central European and Baltic countries' regimes.

As table 3 demonstrates, since early 2001 (the time of the floating of the Turkish lira) two diverging tendencies seem to have emerged in Southeastern Europe: A number of smaller countries/ territories (the largest one being Bulgaria, which joined the EU in January 2007) are holding on to the euro as a nominal anchor (from tightly managed float to euroization). In contrast, a smaller number of mostly larger countries (incl. the new EU members Romania and Turkey) have progressively opted for inflation targeting (at least of an informal kind) and have thus loosened up their currency regimes and connections to the euro and reverted to loosely managed floats. Neither Bulgaria nor Romania have yet joined the ERM II.

Since the late 1990s some differentiation could also be observed among the transition countries further north, although the clearly dominating tendency of the currencies of the Central European and Baltic states that all joined the EU in May 2004 has been to progressively align themselves with the euro. Some – but not all – of these new EU members have entered ERM II, and Slovenia has gone all the way – to the adoption of the common European currency in January 2007. In 1997 the Czech Republic, and in 2000 Poland – two relatively large countries – had somewhat weakened their links to the euro by passing from euro-dominated exchange rate corridors to free or managed floats, which remain valid today. All other Central European and Baltic countries have exclusively anchored their currencies to the euro, and given existing obligations and perspectives, there can be no doubt about the long run.

Nevertheless, as can be seen in table 3, a common trait across the whole region (North and South) seems to be to opt for inflation targeting in all cases (incl. ERM II) except where hard euro pegs are chosen or where the euro is legal tender. As of May 2007, inflation targeting (sometimes informal) was the policy in Albania, the Czech Republic, Hungary (which also committed to a wide-band euro peg), Poland, Romania, Serbia, Slovakia (ERM II), and Turkey. Thus, the largest countries of the region followed this strategy. In contrast, hard euro pegs reigned in the three Baltic states (all of them also ERM II), Bosnia and Herzegovina, Bulgaria, Croatia, and Macedonia. The euro was legal tender in the euro area member Slovenia, in Kosovo and Montenegro.

Table 3: Central and Southeastern European Countries' Monetary Characteristics

| Country/ territory | Currency (since); previous | Exchange rate regime (since); previous | Monetary policy framework (since); previous framework |
|---|--|--|---|
| Central Europe and Baltics | | | |
| <i>Czech Republic</i> | Czech koruna (CZK, Jan. 1993) | Managed float (May 1997), reference currency: EUR (DEM) | Inflation targeting (Jan. 1998) |
| <i>Estonia</i> | Estonian kroon (EEK, June 1992) | ERM II (June 2004), currency board: peg to EUR (DEM) (June 1992) | Nominal exchange rate anchor EUR (DEM) (June 1992) |
| <i>Hungary</i> | Hungarian forint (HUF) | Wide-band peg to EUR ($\pm 15\%$) (October 2001) | Inflation targeting (June 2001) coupled with nominal exchange rate anchor EUR |
| <i>Latvia</i> | Latvian lat (LVL, June 1993) | ERM II (2 May 2005), peg to euro (1 Jan 2005); peg to SDR (band of $\pm 1\%$) (February 1994) | Nominal exchange rate anchor EUR (Jan. 2005), previously SDR |
| <i>Lithuania</i> | Lithuanian litas (LTL, June 1993) | ERM II (June 2004), currency board: peg to EUR (Feb. 2002) | Nominal exchange rate anchor EUR (Feb. 2002) |
| <i>Poland</i> | Polish zloty (PLN) | Free float (April 2000), no foreign exchange interventions since 1998 | Inflation targeting (Jan. 1999) |
| <i>Slovakia</i> | Slovak koruna (SKK, Jan. 1993) | ERM II, standard fluctuation band (28 Nov. 2005), managed float (Oct. 1998) | Inflation targeting (Dec. 2004) coupled with nominal exchange rate anchor EUR (Nov. 2005) |
| <i>Slovenia</i> | Euro (Jan. 2007); Slovenian tolar (SIT, Oct. 1991) | Member of euro area (1 Jan. 2007); ERM II (28 June 2004), tightly managed float (Oct. 1991), reference currency: EUR (DEM) | Euro area (Jan. 2007); nominal exchange rate anchor EUR (June 2004) |
| Southeastern Europe incl. Turkey | | | |
| <i>Albania</i> | Albanian lek (ALL) | Loosely managed float (early 1990s), major reference currencies: EUR, USD | Informal inflation targeting through money growth targeting (Jan. 1998) |
| <i>Bosnia and Herzegovina</i> | Konvertibilna marka (BAM, June 1998) | Currency board: peg to EUR (DEM) (formally introduced: August 1997, de facto since mid-1998) | Nominal exchange rate anchor EUR (DEM) (August 1997) |
| <i>Bulgaria</i> | Bulgarian lev (BGN) | Currency board: peg to EUR (up to end-1998: to DEM) (since July 1997) | Nominal exchange rate anchor EUR (DEM) (July 1997) |
| <i>Croatia</i> | Croatian kuna (HRK) (May 1994) | Tightly managed float, reference currency: EUR (up to end-1998: DEM) (since Oct. 1993) | Nominal exchange rate anchor EUR (DEM) (Oct. 1993) |
| <i>Kosovo/ Kosova (Serbia)</i> | | All foreign currencies legalized for transactions, EUR (DEM) predominant, YUM used regionally (Sept. 1999) | EUR legal tender (Sept. 1999) |

Table 3 continued: Central and Southeastern European Countries' Monetary Characteristics

| | | | |
|---------------------------------------|--|---|---|
| FYR Macedonia | Macedonian denar (MKD, April 1992) | De facto peg to EUR (exchange rate target, up to end-1998: DEM) (since Oct. 1995) | Nominal exchange rate anchor EUR (Oct. 1995) |
| Montenegro | Unilaterally euroized/EUR (Nov. 2000) | | EUR legal tender (Nov. 2000) |
| Romania | Romanian leu (RON, redenominated July 2005) | Loosely managed float (Aug. 2005); managed float (1991), reference currency: EUR (since early 2005) | Inflation targeting (August 2005); Money growth targeting (early 1990s) |
| Serbia (without Kosovo/Kosova) | Serbian dinar (RSD, from 2003 until end-2006 called CSD) | Loosely managed float (Feb. 2006); managed float (Jan. 2003), reference currency: EUR | Informal inflation targeting through "inflation objectives" (Sept. 2006); real exchange rate anchor (Jan. 2003) |
| Turkey | Turkish lira (YTL, redenominated Jan. 2005; TRL) | Loosely managed float (Feb. 2001), major reference currencies: USD, EUR | Inflation targeting (Jan. 2006); Money growth targeting, informal inflation targeting (Feb. 2001) |

Source: Compiled by Stephan Barisitz, OeNB.

Of course, the whole framework of macroeconomic policies is relevant for successful economic policies and smooth monetary integration in particular, but some elements have proven to be of specific importance by historical experience. Among these are some of the most basic challenges of the macroeconomic framework, like the question of fixed versus flexible exchange rates, the specific conditions relevant for small open economies (SMOPEC), the challenges created by the so-called policy trilemma. In the end it took almost two decades until fixed exchange rate regimes regained in importance as a reliable policy framework to stabilize the macroeconomic situation of a country.

The second important basic element to be considered in this respect is the SMOPEC characteristic or assumption that gained particular importance in the discussions following the Mundell-Fleming model of fundamental open-economy characteristics. Introduced at the time mainly to allow for differences concerning optimal currency area (OCA) preconditions between large and small countries, SMOPEC characteristics turned out to be instrumental in making open-economy analysis and results more realistic, given the differences in country size across the EU. Essential elements of this perspective are that small countries are usually price-takers on international markets, that they are characterized by a high share of constant return industries, a high concentration of product/industry specialization, a high geographic concentration of production as well as an overall high share of foreign trade in GDP. As a result small countries typically face a higher likelihood of asymmetric shocks, a fact that creates a challenge for all types of fixed exchange rate arrangements.

A different set of criteria for exchange rate regime choice than that based on the benefits of integration versus the benefits of monetary independence, is based on the concept of a nominal anchor (Bordo, 2004). In an environment of high inflation, as was the case in most countries in the 1970s and 1980s, pegging to the currency of a country with low inflation was viewed as a precommitment mechanism to anchor inflationary expectations. In an SMOPEC a pegged exchange rate may promote such a precommitment device, at least as long as the political costs of breaking the peg are sufficiently large. This argument was and is used to make the case for the Exchange Rate Mechanism (ERM) in Europe and for currency boards and other hard pegs in transition and emerging countries.

Summing up, the confidence and stability-enhancing effect of hard pegs appears to have borne out success in most of the countries analyzed; but this does not preclude other monetary strategies – notably inflation targeting and a loose float – from being effective as well. Overall monetary and economic policy soundness, credibility and perseverance remain the key to success here. In particular, prudent fiscal policies and general policy discipline, possibly favored by peer pressure within the Southeastern European region, IMF surveillance and EU membership aspirations (now already fulfilled in the cases of Bulgaria and Romania), have assisted the central banks in pursuing their goals.

6. A Little Bit of “Current” History: ERM II and the Road towards Monetary Union

EU integration is a rule-based process. This also holds true for monetary integration. According to the Maastricht Treaty monetary integration takes place in stages, leading from EU membership through participation in the Exchange Rate Mechanism II (ERM II) to eventual euro area membership.

Upon accession to the European Union, new Member States are required to treat their exchange rate policy as a matter of common interest and to pursue price stability as the primary objective of monetary policy. Beyond these obligations, the choice of the monetary and exchange rate strategy remains, during this phase, a responsibility and prerogative of the Member State concerned.

Participation in ERM II, which is a multilateral arrangement of fixed, but adjustable, exchange rates between the currencies of Member States participating in the mechanism and the euro, involves an explicit exchange rate commitment. This commitment must be compatible with the other elements of the overall policy framework, in particular with monetary, fiscal and structural policies. Countries that submit a request for ERM II entry have, thus, to be appropriately prepared: “To ensure a smooth participation in ERM II, it would be necessary that major policy adjustments are undertaken prior to entry into the mechanism and that a

credible fiscal consolidation path is being followed.” (European Central Bank, 2003).

It is important to note that ERM II has two roles. One is to act as an arrangement for managing exchange rates between non-euro area Member States and the euro area, and the other is to play a role in the convergence criteria for joining the euro. As regards the second role, ERM II acts as a testing phase (“training room”) for both the central rate and the sustainability of convergence in general. By joining the EU, new Member States undertake the commitment to strive towards the eventual adoption of the euro upon having fulfilled the convergence criteria laid down in the Treaty in a sustainable manner. The assessment on the fulfilment of the criteria is made on a case-by-case basis, taking into account the specific situation of each individual country. It is based on the principle of equal treatment across Member States and time.

With regard to exchange rate stability, which is of particular interest in the context of this conference volume, the criterion refers to participation in ERM II for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro. The Governing Council position points out that “the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate while also taking into account factors that may have led to an appreciation, which is in line with what was done in the past.” It also stresses that the width of the fluctuation band within ERM II shall not prejudice the assessment of the exchange rate stability criterion. Finally, it recalls that the issue of absence of “severe tensions” is, in general, addressed: (i) by examining the degree of deviation of exchange rates from the ERM II central rates against the euro; (ii) by using indicators such as short-term interest rate differentials vis-à-vis the euro area and their evolution; and (iii) by considering the role played by foreign exchange interventions.

Finally, as underlined by the EU Council in November 2000, any unilateral adoption of the single currency outside the Treaty framework – by means of unilateral euroization – would run counter to the economic reasoning underlying Economic and Monetary Union, which perceives the adoption of the euro as the end-point of a structured convergence process within a multilateral framework.

7. Any Conclusions?

Which exchange rate regime is appropriate for which country? Despite the extensive scientific knowledge on this important question, real world uncertainty leaves us with a substantial range of indeterminateness when trying to find an straightforward answer to it. Obviously, potentially sustainable exchange rate regimes can be related to four different groups (Crockett, 2004): (i) fully fixed rates, in particular if they come close to abandon the individual exchange rate of a country, (ii) pegging regimes, when they are supported by appropriate economic

policies or framework conditions, (iii) managed floating regimes, when market expectations concerning exchange rate “moves” or “instability” never become too strong and (iv) free floating regimes, where countries have to accept the potentially real economy consequences of this choice.

A particular problem in this respect is the move from one currency regime to another. Countries which have once for specific – and possibly well justified – reasons embarked on the road to a particular exchange rate regime are “tied” to a large extent to this particular choice because of market pressure as well as potentially bad expectation formation and consequent exchange rate instability. Although the choice of an exchange rate regime may certainly be seen as an outstanding economic policy challenge, the transition from one regime to another one – think, for example, of the transition from a well established currency board to managed floating – obviously means a multiplication of problems, with unclear results.

Long-term historical tendencies may suggest, that an increase in capital mobility tends to make intermediate exchange rate regimes disappear, in favour of the extremes of currency boards or monetary union on the one hand, and freely flexible exchange rates on the other. But one has also to take a view, if the abandonment of intermediate exchange rate regimes is the result of voluntary choice or if countries are forced to exit, for example because of a speculative attack. The latter explain the exit from an exchange rate peg as triggered by the action of speculators. But if a forced exit involves a sort of choice between alternative regimes, then both elements would be present at the same time. Therefore, forced exit – even preventive strategies of exit – could lead into a situation of new equilibrium if the right choice is made at the right time and respective framework conditions allow for implementing such a choice. No doubt, explaining transitions between exchange rate regimes and their consequences is the central challenge – countries in particular countries of the CESEE area face nowadays on their way into – eventually – monetary union.

Taking into account that countries have to choose their exchange rate regimes for a variety of international and domestic reasons, one obvious requirement is that all actors surely understand the properties of alternative – or potential – regimes. There are some important trade-offs in the choice of the exchange rate regime. On the one hand, an exchange rate regime can promise to impose policy discipline, thereby stabilizing expectations and creating confidence in the currency. On the other hand, no exchange rate regime can substitute for sound macroeconomic management, leaving the burden of doing the right things to policy makers again. Nevertheless, countries have to decide upon their particular regime at any given point in time. Because of this, this is clearly an issue where the “art” component of economic policy making becomes important. Historical experience and evidence can be of valuable help as ingredients in making far ranging decisions on issues like this. Without doubt, the choice of the appropriate exchange rate regime will

stay with us as one of the important open questions in academics as well as in economic policy making for some time, if not decades. Obviously, whatever choice it will be makes an important difference: Consider, for example, a comparison of the Gold Standard framework with nowadays world: Decisions on interest rate policies would be guided by completely different reasons and lead to completely different outcomes.

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