III.1. CURRENCY BLOCS: LOOKING AT THE OPTIONS FOR DEVELOPING COUNTRIES IN A MULTIPOLAR MONETARY REGIME

Introduction: Developing Countries, the "Original Sin" of Foreign Debt and the Instabilities of a Multipolar World

For developing countries tainted by "original sin," as Hausmann (1999: 67f.; see also Eichengreen/Hausmann/Panizza 2002) labeled them, currency regime requirements are specific. Even economically promising and reasonably open countries are able to attract only short-term finance in their national currency and only foreign currency, e. g. dollar, loans for long-term investment finance. The weakness of the national currency traps them in a state of financial fragility that makes them extremely vulnerable. Both sudden declines in the volume of liquidity within the banking system and sudden currency depreciations will always lead to a run on foreign currency by national investors and banks, since investments will suffer either from a currency mismatch (because projects that generate local currency are financed by dollar loans) or a maturity mismatch (because longer-term investments have been financed with short-term loans). This decision – from the investors' standpoint a highly rational one – will lead to further depreciation, regardless of the formal exchange rate regime that the country pursues. "In fact, such a system is subject to self-fulfilling crises, as in a bank run: If people fear that others may take their money out, they will want to be the first out the door" (Hausmann 1999: 68).

In Latin America's case, this "original sin" should in fact be seen as a "congenital defect," given that the first external debt agreements stem from the very first days of independence and creation of a national currency. In a Keynesian sense (Keynes 1935) it represents nothing but a low liquidity premium on developing countries' currencies that is the expected non-pecuniary return for holding a certain currency in comparison to other currencies. Its seems evident that the overwhelming majority of economic actors will prefer holding US dollars or euros or Swiss francs rather than, say, Mexican or even Argentine pesos. From this Keynesian viewpoint, which focuses its understanding of economic processes on the fact that uncertainty is the ultimate motivation for any rational behavior by economic agents and which treats money as a medium that is able simultaneously to reduce and to produce this "state of uncertainty," the liquidity premium of a national currency proves to be the crucial criterion for economic development (Nitsch 1995). Indebted countries' currencies are permanently liable to devaluation, thereby producing a low liquidity premium that makes national and international wealth owners alike shun this type of currency not only at times of crisis, but constantly. In the short run, the only way to stop or even reverse this process of monetary and financial meltdown is to increase the internal interest rate substantially, compensating for low non-pecuniary returns by high pecuniary returns and thereby suppressing national investment and income. So it turns out to be the crucial factor hindering development. In this sense, any development strategy has to focus on the aim of raising the liquidity premium. Such a strategy would not only require a reduction of inflation to the key currency's level, as orthodox theory suggests. It also requires nominal stabilization of the currency's price, i. e. the exchange rate, specifically liberating it from being seen as liable to future devaluations as a consequence of foreign debt. The requirements for a policy oriented toward increasing the liquidity premium are generally high. For countries that carry high external debt burdens and whose currencies are marked by a long history of inflation and currency crises, this represents an extremely challenging set of policy goals, ranging from inflation rates equal to or even lower than those of the international key currencies to a fiscal balance or even a surplus in public budgets and nominal stabilization of the exchange rate, and that have to include a marked, ad continuous surplus in the trade balance such as to lead to a substantial reduction in the stock of foreign debt. Still, since the liquidity premium is a result of the "general reputation" of a country and its currency the outcome of such policies, reflected in successive reductions in the equilibrium interest rate, would tend to be long-term, while in the meantime the costs could be rather high.

In this context, the selection of an adequate currency regime, i. e. the sum of monetary polices and the type of exchange rate regime chosen is far from being a sufficient condition for sustained economic development. However, since it does exert great influence on the liquidity premium, it seems to be worth looking at more closely.

The choice of a currency regime at the national level always has to be seen in the context of the predominant international monetary and financial regime. Currently, conditions are anything but easy for developing countries. Not only does widespread financial liberalization make it difficult not to resort to external debt for financing domestic growth (at least in times of abundant supply of international capital).[1] Since the end of Bretton Woods, the international monetary order has been marked by multipolarity. The US dollar's decline from its original position as the leading international currency gave way to competition between three key currencies, (the US dollar, the deutschmark/euro and the yen).[2] This competition (between rather unequal currencies in respect of their quality and functions within the international monetary system; see e. g. Krugman 1984) has led to major instabilities as changes in the respective interest rate levels trigger remarkable shifts of nominal wealth from one currency to another. A further consequence of this permanent competition is that the inflation rates of those key currencies have declined significantly since the 1970s. Therefore, if developing countries want to defend their national currency against those key currencies they are forced to produce at least similarly low inflation rates, with high economic and social costs.

One central issue for the choice of a currency regime is that the present tendency toward regionalization of trade and of building formal economic blocs among neighboring nations – the outstanding example being the European common currency, the euro – has to be understood as a strategy of immunization against these international monetary instabilities.

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[1] Ricardo Ffrench-Davis (1999) has called the supply of abundant and relatively cheap international capital flows to developing countries during the 1990s the "plata dulce," the apparently easy money.

[2] Often the current order is called a tripolar one, but the uncertainty about the yen's quality does lead some authors to characterize the current order as a bipolar one. For the question to be treated here, the options developing countries have for their currency regime, it does not make a systematic difference if we have to presume a bi- or a tripolar world.

Economic Bloc Building and Options for Developing Countries' Currency Regimes

The mainstream debate around currency and exchange rate regimes at the end of the 1990s has centered on a new consensus proclaimed prominently by the International Monetary Fund (Fischer 2001; Mussa et al. 2000). The “corner solution” is based on the lessons learned from the series of financial crises that shaped emerging market economies in the second half of the 1990s. The intermediary exchange rate regime that most countries had chosen is said to be mainly to blame for the financial crisis, as it proved to be prone to speculative attacks. Especially in conditions of free capital movements, it is said, the preference should be for a so-called two-corner solution, i. e. a free floating exchange rate or, at the other extreme, the option of a very hard peg. The latter refers to the establishment of a currency board or even to abandoning the national currency and declaring a foreign currency the sole legal tender in the economy.[3]

Not only since the collapse of the Argentine currency board, belief in this new consensus has suffered severe damage, though without giving way to a new recipe for what kind of exchange rate regime developing countries ought to opt for today. Taking into account the international trend toward building economic blocs, it seems to be more fertile to understand the exchange rate system options for developing countries excluded from these formal economic blocs around the international key currencies not as a choice between corner solutions on the one side and intermediary regimes on the other, but rather to formulate four types of regime, focusing on their relations to the big economic blocs around the three key currencies:

a) an attempt at an independent currency regime;

b) unilateral subordination to one of the key currencies (“dollarization”);

[3] To be analytically correct, in the case of a strategy of unilateral dollarization, or, generally, of abolition of the currency by establishing a foreign, hard currency as the only means of payment we have to talk about a “non-regime” as in this case the exchange rate is abandoned altogether.

c) coordinated integration[4] into one of the currency blocs centered around a key currency (North-South Cooperation – NSC);

d) a currency bloc of external debtor countries (South-South Cooperation – SSC).

The following sections will deal briefly with each of these options, taking into account their respective contribution toward economic development in terms of strengthening the national currency (increase in the liquidity premium).

a) Independent Currency Regime

Formally, an effort to take forward a currency regime independently from the (blocs around the) key currencies can be made by means of a regime of free floating. For economies marked by the "original sin" of foreign debt, however, this option proves to be problematic since, in the context of the unstable multipolar international monetary regime, a heavily fluctuating exchange rate proves for foreign debtor economies. With liberalized capital flows, the exchange rate tends to gain strongly in value during boom times of high capital inflows only to be devalued even more in times of bust when capital flows reverse. While revaluation of the currency will create an incentive for attracting foreign currency debt, the contrary exchange rate movement will produce a currency mismatch, creating a real debt problem for debtors in foreign currency whose returns are basically in domestic currency (both business and banks). The consequent insolvencies in the real sector and/or the banking sector will call into question the solvency of the debtor nation as a whole.

A volatile exchange rate is the opposite of what is required for improving the quality of any currency. The heightening of the state of uncertainty results in a further reduction in the liquidity premium. Therefore, the typical picture that has emerged in recent is an increase in the number of

4 It is to be noted that the terms "monetary coordination," "monetary cooperation" and "currency union" are used rather interchangeably even though they represent different levels of monetary integration (for a definition of the terms, see Steinherr 1984; for a more detailed view on the stages of monetary regionalism, see Dieter 2000).

countries that formally let their currency float freely, but in the majority of these cases central banks have intervened repeatedly (be it directly in the foreign exchange market or indirectly by way of their monetary policy) to prevent the exchange rate from fluctuating too strongly. First, however, the difference between a free-float regime and an intermediate regime is lost. Second, in the case of an external debtor economy the aim of pursuing an independent exchange rate policy makes it necessary to adopt a monetary policy that hinders the creation of income in the national currency.

b) Unilateral Subordination to a Key Currency ("Dollarization"[5])

To be precise, one has to differentiate between a process of market-driven dollarization such as is observed repeatedly in foreign debt economies marked by macroeconomic instability, and a unilateral policy of dollarization or, more generally, the adoption of a foreign hard currency as the only means of payment in the domestic economy.

Abandonment of the national currency is the furthest-reaching form of subordination to a key currency as the new and only legal tender in the economy. It corresponds to the hard peg variant in the two corner solution paradigm. To put it simply, the establishment of a currency board will be subsumed under the strategy of dollarization, since its logic and consequences do not differ qualitatively from that of a rigidly fixed exchange rate regime. Still, the dollarization option has to be considered the more radical one, as (among other reasons) the exit option, the return to re-establishing a domestic currency, seems to be more difficult once it has been abandoned.

The advantage of abandoning one's own currency, be it unilaterally (case b) or bilaterally (case c) for a foreign debtor country at first level proves to be the same: that country is spared the effort of defending the exchange rate of its own currency unilaterally.

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[5] The expression "dollarization" has been established in the academic debate (see Berg/Borensztein 2000; Gomis-Porqueras et al. 2000; Guidotti/Rodriguez 1992), though theoretically one could also talk of a "DMarkization," "euroization" or "yenization."

The theory of optimum currency areas established by Mundell (1961), centering on an evaluation of the advantages of a currency union of this kind and the costs of renouncing any resort to the exchange rate as an instrument of active economic , is not valid for currencies with a low liquidity premium. A devaluation of the currency in response to exogenous shocks (stemming from a change in the national terms of trade or in the international interest rate level) may eventually produce positive results in the trade balance. But they are likely to be outweighed by the inflationary impetus resulting from nominal devaluation and the real-debt effect on the domestic economy. Hence the external debtor economy devaluation is not able to solve a balance of payments problem, but rather changes the appearance of that problem. Potential stabilization of the balance of payments is achieved at the cost of destabilizing domestic economic relations.

In that sense, the strategy of pegging a currency unilaterally offers a key advantage over the effort to defend a national currency unilaterally. It eliminates the need to defend the change rate and the exchange rate risk shrinks to zero, as in the extreme case of a complete currency substitution (case b) or a currency union with a key currency (case c) the exchange rate simply no longer exists. Therefore, the equilibrium interest rate can fall substantially and, other things being equal, thereby encourage a process of strong economic growth.

While the second generation of literature on currency unions focuses on the advantages of getting rid of a discredited national body with discretionary economic policy powers, the Central Bank, and on the strong pressure exerted by fixing the exchange rate definitively, or abandoning it, for fiscal and wage policies to adapt to the new conditions, the argument defended here proves to be much stronger.[6]

The crucial problem of unilateral fixing or adoption of a foreign currency is the complete loss of the function of lender of last resort. The unlimited offer of liquidity cannot be substituted by way of private commercial banks, as has been proposed for both currency boards and fully dollarized economies (Caprio et al. 1996; see also Berg/Borensztein 2000). The bitter

6 For the discussion of this topic, see Jameson (2001).

proof of this was seen in the case of Argentina, where a special contract for that purpose between the Argentine state and a number of private international banks broke down completely when balance of payment problems, accompanied by a growing shortage of liquidity in the domestic banking sector, proved serious. First, the establishment of a contingency credit line to be resorted to in case of emergency is no substitute for an unlimited offer of liquidity by a Central Bank, the rediscount line. Second, if a liquidity crisis looms, banks involved in this kind of contract simultaneously have unlimited possibilities of reducing their liquidity supply, and therefore their exposure to risk. Instead, it can be seen empirically that the state, in the effort to substitute the missing lender of last resort at a time of growing liquidity problems, transforms itself into a "debtor of last resort" (Frenkel 2001: 112; see also FitzGerald 2001: 128) by issuing a growing amount of foreign debt itself. If the country is unable to generate current account surplus, a continuing liquidity problem creates an especially problematic constellation. In this situation, the only way out it is a policy of deflation, that is a strategy to reduce the real and the nominal value of prices and wages, which brings about a deep recession in the domestic economy. Not only will this reduce fiscal income and call the state's solvency into question, but the increase in public debt ratios (that are triggered in this case by adverse macroeconomic conditions and not by any form of deficit spending) will impair the banking sector's portfolio quality.

So one must conclude that the advantage of unilateral subordination of the currency, that is the disappearance of the exchange rate risk, is more than offset if the economy is unable to generate a permanent current account surplus. By creating a strongly pro-cyclical combination of exchange rate, financial system and fiscal default risk the sovereign solvency risk increases greatly (for the case of Argentina, see e. g. Dullien 2002).

If the absence of the lender of last resort function makes the strategy of unilateral adoption of a foreign hard currency extremely costly in terms of a national development strategy, it can still make sense for a country that already shows a high degree of dollarization together with a high degree of integration (being it through intensive financial or trade relations) with the adopting currency's country. Some Central American countries fulfill this condition. The argument is that in this type of economy the lender of last resort function is already largely absent, so the room for action on domestic monetary policy is very limited, and such action can easily have destabilizing effects that intensify the dollarization process. In this case, the loss of autonomy would not be very significant. Still, to prevent the kind of deflation and solvency crisis described above, a necessary condition is that this fully dollarized economy must have reliable, i. e. constant and relatively stable, sources of foreign net currency income, be it an export surplus or, for example, a high volume of remittances sent home by migrants abroad. In this case, unilateral subordination to a key currency may at least prevent the economy from further destabilization.

c) Coordinated Integration in a Key Currency Bloc (North-South Cooperation)

Coordinated integration in a key currency bloc should certainly be seen as the most advantageous option for external debtor countries. This refers to cooperation between k currencies in a world of n currencies, where the k^{th} currency, the key currency, pursues a goal of internal stabilization of the price level, while the (k-1) members pursue the goal of stabilizing the exchange rate against the leading regional currency.

For NSC to be sustainable, it must be cooperation between explicitly asymmetric currencies in the sense that interest rate changes in the k^{th} currency have much greater consequences on the (k-1) countries than vice versa, because the k^{th} currency is a net creditor economy while the (k-1) countries are defined as external debtor economies, this external debt being denominated in k.

While from the perspective of older theoretical approaches this represents all but optimum currency area, the new literature on the topic offers the possibility of turning this argument into its opposite. The first generation of literature concentrated basically on the effects of a common currency on trade. The second generation has added a second aspect, concerning the credibility of a common currency in relation to monetary stability. Yet while the mainstream literature seeks this credibility effect in the shift from a national, discretionary economic policy to a multilateral, rule-based one[7], the argument defended here is that it is conglomeration around a key currency that lends credibility to the goal of common monetary stabilization as a necessary means of development.

From the perspective of an external debtor economy, this option, contrary to that of unilateral currency substitution, combines the advantage of a reduction in the interest rate with the establishment of a lender of last resort for the economy as a whole. The establishment of a common currency (that being the original key currency or a new one closely oriented to the standard established by the original key currency) not only abolishes the exchange rate risk within the new currency area, but it also eliminates the external debt status of the (k-1) countries. The lender of last resort function in the case of a common currency is exercised by the regional central bank. In a multilateral currency cooperation arrangement, the key currency's central bank commits itself to intervene to stabilize the debtor countries currencies. Especially because of that commitment, the key currency country will make harmonization of economic policy goals in line with its own standards a necessary condition for going ahead with the cooperation project. This is aimed to prevent the costs of cooperation for the key currency economy becoming enormous.

This option offers exceptional conditions for economic development in the sense of an increase in the liquidity premium compared to the other cooperation members, especially when a country can produce an inflation rate lower than the rest of the region, thereby becoming more competitive and achieving higher growth rates. The disadvantage of a common currency arrangement of this kind, including for countries in the South, could be that the establishment of rigid rules, installed in order to prevent misuse of the common currency (or the established exchange rate mechanism) by discretionary policies geared toward the short term, could bind fiscal (and monetary) policies in a way that put counter-cyclical intervention out of reach (Eichengreen/Wyplosz 1998: 92-97). These contrasting results would make it difficult to determine the net effects of a currency union.

[7] Alesina/Barro 2000: 19ff.; Bayoumi/Eichengreen 1994: 7; De Grauwe 1994; for a critical discussion, see Schelkle 2001: 33.

The planned enlargement of the European currency union to include a number of East European countries in the years ahead is a clear case of NSC. The only deviation from standard is that not all East European countries have “euro-ized” their economies. In some of the states, at least, the US dollar plays an important role. The same applies to the idea – that up till now has been put forward almost exclusively by the Mexican side – about a monetary cooperation in the North American Free Trade Agreement (NAFTA) area.[8] However, the 1999 “ASEAN plus 3” agreement between East Asian countries, including Japan, to strengthen regional monetary cooperation is a case that does not fall easily into any of the categories defined here. Unlike in the “classical” case of NSC, the yen’s status as a key international currency is not clear. As regards the issue of regional integration, this is shown by the fact that most of the foreign debt of the countries in the region (as well as intra-regional trade and financial contracts) is not denominated in the regional key currency but predominantly in US dollars.

However, the majority of developing countries cannot be expected to gain access to a NSC. Aside from political interests and blockades, the economic interest of integrating any regional key currency with weaker currencies must be limited, unless it wants to run the risk of thereby ruining its own liquidity premium. In fact, from the viewpoint of the creditor economy, integration of external debtor economies with a very low liquidity premium would lead to the debtor countries’ economic stabilization and therefore improve the quality of its financial claims. On the other hand, the central bank would be committed to supporting fragile banking systems with potentially high intervention requirements. Potential fiscal burdens also arise from the typically fragile fiscal systems in debtor countries. Moreover, growing economic integration will be accompanied by pressure to liberalize migration policies, with serious consequences for wage levels in the key currency country. For all these reasons, it appears rather unrealistic to expect a multilaterally coordinated extension of the US dollar to the entire subcontinent of Latin America.

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[8] For the discussion on monetary unification within NAFTA, see e.g. FitzGerald (2001); Fritz (2003); and Ibarra/Moreno-Brid 2001a and 2001b.

d) Currency Bloc of External Debtor Economies: South-South Cooperation[9]

From the perspective of the first generation literature on common currencies, cooperation (or creation of a common currency) between external debtor economies fulfills the criterion for an optimum currency area of symmetry, in the sense that all members react in the same way to external shocks stemming from a change in the international interest rate level. Therefore, currency bloc members can dispense with the exchange rate as an instrument for adapting to changing conditions.[10] Consequently, SSC is cooperation among k currencies in a world of n currencies without the inclusion of a k^{th} currency at the center of a group of (k-1) currencies.

This is not to say that SSC agreements are by definition marked by non-hierarchical relations. The central criterion for differentiating South-South Cooperation (SSC) from NSC is that the former lacks a currency able to follow a (relatively) independent policy of monetary stabilization. A typical example of SSC would be a common currency for the *Mercosur*, the southern cone economies of Latin America. In recent years, member states have repeatedly agreed to gear their policies toward this goal (but with rather unclear conditions for realization so far).

The strongest reason for the intensifying discussion about setting up SSC projects can surely be found in the introduction of the euro (an experiment with a highly successful outcome, at least from the viewpoint of countries in the South), along with the obvious exclusion of the majority of external debtor countries from NSC agreements. Beyond that, some economic arguments in favor of SSC can be found. Taking into account the arguments of the new growth theory with their focus on the advantages of knowledge-based production linked to regional diffusion, and to economies of scale, a deepening of SSC integration can enhance member states' competitiveness. In that case, to maintain regional integration monetary cooperation is necessary, because volatile exchange rates increase the risks for economic activity within the region and are therefore an obstacle to trade integration. Furthermore, without mone-

9 For an overview on the discussion of currency unions of developing countries see Agosin (2001); IDB (2002); and Unctad (2001).

10 (Unctad 2001: 124). In relation to the criterion of homogeneity, however, it is not said to be the same by definition, as production patterns and wage formation can differ substantially between neighboring external debtor countries.

tary cooperation beggar-thy-neighbor policies will undermine political motivation for a policy of integration (Fritz 2002; Heymann 2001; IDB 2002: 171ff.). The open crisis within Mercosur that started with the Brazilian currency crisis in early 1999 and intensified with the implosion of the Argentine Currency Board in 2002, is a clear example of this.

Thus the outstanding advantage of SSC consists in the fact that it neutralizes competition between external debtor member states for foreign currency income and capital inflows. Moreover, diversification of production could immunize the external balance of payments against the volatility of terms of trade. Last but not least, the establishment of a common currency could lead to national monetary, fiscal and wages policies being committed more strongly toward monetary stability. This would enhance the liquidity premium, provided that this strategy goes hand in hand with a reduction in foreign debt by means of an export surplus. The latter argument, i. e. that externalization of economic policy institutions makes new priorities politically feasible, relates to political economy. Still, it can certainly be significant in the realization of monetary integration projects among debtor nations.

The main argument against the sustainability of SSC in the sense of opening up new development perspectives, however, can be found in the reversal of the credibility argument put forward in the discussion of NSC. Since a SSC is nothing more than a bunching of similar currencies with relatively similar liquidity premiums, the only argument to be found in favor of changing the currency regime relates to political economy. There is no argument based on market processes as to why the unification of the SSC currencies should lead to a reduction in monetary volatility compared to the situation prior to unification. The regional enlargement of a weak currency area leaves the question of external relations with the international key currencies relatively unchanged, while internally there is still no lender of last resort for financial contracts denominated in foreign currencies. If the region seeks a flexible exchange rate regime, the same arguments apply as to a strategy of free float of a single external debtor currency (see case a). Unilateral pegging, to the contrary, leads to the problems discussed under case b.

Conclusions

Summing up, it can be said that currency regimes are not the only factor determining economic development, but that in a context of a fragmented international monetary order and international regionalization as a result of this destabilizing fragmentation, developing countries have to evaluate each option carefully in terms of its consequences for the domestic currency's quality. Much research has to be done both into further clarifying the definition of existing currency regime options within this international context and into the empirical foundation, looking more closely at the growing number of common currency projects among developing countries. As long as Latin American economies in particular seem to be prone to further currency crises, the debate on monetary cooperation will remain of key importance for the subcontinent's economic future. But within the approach in this paper it seems to be possible to rank the (at least in theory) available for macroeconomic longer term stabilization reasons under the current global conditions as following:

The first best solution for a developing country would be the bilateral inclusion into a North-South monetary integration scheme, resulting in the completion of the lender of last resort function and being accompanied by structural transfers intended to reduce income level differences. This is the treatment that "southern" economies of the European Union (Greece, Portugal, Ireland) have received and that led to substantial increases in the respective national income of these economies.

But as this option is, at least for now, not available for the Latin American countries, due to the fact that United States are not willing to commit themselves to any kind of bilateral monetary or macroeconomic agreements on global or regional level, we have to evaluate the chances and risks of the resting options, even if these are to be considered as second best options.

As the "dollarization" option leaves to the complete loss of the lender of last resort function, it makes the strategy of unilateral adoption of a foreign hard currency extremely costly in terms of a national development strategy. But it can still make sense for a country that already shows a high degree of dollarization together with a high degree of integration (being it through intensive financial or trade relations) with the adopting currency's country. Still, to prevent the kind of deflation and solvency crisis described above, a necessary condition is that this fully dollarized economy must have reliable sources of foreign net currency income. In this case, unilateral subordination to a key currency may at least prevent the economy from further destabilization.

As deepening of South-South Cooperation can enhance member states' competitiveness, it turns to be necessary to maintain regional integration monetary cooperation, because volatile exchange rates increase the risks for economic activity within the region and are therefore an obstacle to trade integration. Furthermore, without monetary cooperation beggar-thy-neighbor policies will undermine political motivation for a policy of integration. But there is no argument based on market processes as to why the unification of the SSC currencies should lead to a reduction in monetary volatility compared to the situation prior to unification. But externalization of economic policy institutions can eventually make new priorities politically feasible.