Introduction to Part IV

Sometimes I think that the exchange rate is to international finance what sex is to love. Sex is secondary to love, most people would agree, but sex captures much more space than love in everyday conversation, radio, films, and TV. Similarly, economists and the public in general get all worked up about exchange rate regimes, as if the choice made a big difference, or were even truly possible! Until recently the discussion about the optimal exchange rate regime ignored key aspects of EMs, like liability dollarization and other financial vulnerabilities that trouble EMs. Discussing the exchange rate without context is like sex for its own sake, i.e., pornography.

The following chapters attempt to frame the exchange rate debate in a context relevant for EMs. Chapters 14 and 16 were written at about the same time and carry a simple message: floating ain’t easy. More specifically, it is very difficult for EMs to ignore the vagaries of the exchange rate as mature economies do. EMs know that and de facto peg (witness Russia, China, and Argentina).

Chapter 15 was written in connection with a seminar on dollarization organized by ITAM, Mexico, and the Federal Reserve Bank of Cleveland. Although its main objective was to assess the pros and cons of full dollarization, the chapter focuses rather on the difficulties of assessing alternative exchange rate regimes when key EM characteristics are taken into account. In particular, chapter 15 discusses the incredibly popular optimal currency Area criterion (OCA), for the optimal choice of exchange rate regimes, and concludes that what the OCA leaves out is far more relevant than what it puts in. The discussion is pursued in chapter 17, which reemphasizes the point that the EM context and institutions are critical for choosing the exchange rate regime. Moreover, it dares pro-floating-exchange-rate advocates to meet what might be called the Mundellian challenge: Why stop at countries rather
than extending the discussion to regions, as Mundell (1961) proposed? If you take a stroll down 19th Street in Washington, DC, you will find many pro-floaters, but hardly anyone who favors multiple currencies within a country. Why?

Let me end this section with a plea: Once and for all, let us take pornography out of international finance!

References