THE CHOICE OF THE EXCHANGE RATE REGIMES OF THE EUROPEAN UNION ACCESSION COUNTRIES INFLUENCED BY THE WORLD CURRENCY CONSOLIDATION

Marin Frâncu[1]

ABSTRACT. The pressure of the currency consolidation increased in the years 1990 as the world currency system became obviously too complicated and too costly. There are too many national currencies that generate artificial barriers and avoidable transaction costs, both for the domestic economies and for the world economy. The high costs and great vulnerability of the national currencies determined the financial and economic business of small open economies to move into the major currencies of the world. The world needs fewer national currencies, but does it need fewer central banks too? Or it needs central banks capable to pursuit sound monetary policies? What kind of institutional arrangements and international financial architecture are most suitable for the prospective environment of a greatly reduced multiplicity of currencies? A regional currency consolidation may be a good answer but a regional currency union is a better answer. Though, until membership of the Euro zone, what kind of the exchange rate regime is more suitable for Romania and other European Union accession countries? The hard peg regimes seem not to be a good solution. The best solution lays probable between managed floating regimes and intermediate regimes. This may be because emerging markets have both „fear of floating" and „fear of fixing". But there is no ideal exchange rate regime „to suit everybody". Once the exchange rate regime chosen, it evolves in time. So is the case with the exchange rate benchmarks for the national currency.*

1. Fewer is better

The currency consolidation is a unification process of too many national money standards of the world. **The world currency consolidation means the official national currencies merging into one world currency**. This idea is not new. A world currency, the **„bancor",** was advanced by John Maynard Keynes at the Bretton Woods conference in 1944, but not accepted. Even today it has a few advocates and mostly as a desirable endpoint in the long run. Between them a Nobel laureate, Robert Mundell a supporter of a single world currency. At the other end, another Nobel laureate, Milton Friedman is a supporter of widespread flexible exchange rate regimes and an opponent to one world currency[2]. More accepted is the proposal **that national currencies to consolidate within regional blocs** that have close trading and investment linkages, thus making them more economically and politically sustainable[3] .

1 Marin Frâncu is an economist and senior researcher, and head of programs within the Institute of World Economy, Bucureşti, Romania. He is the author inter alias of „Capital Market", editor Tribuna Economică, December 1998, Bucureşti, Romania and over one thousand articles published in Romanian economic reviews. Last year author's studies in Institute of World Economy: „Major Tendencies in Developing Economies. The Improvement of the Growth Policy Quality", November 2002 and „The Advantages of Romania's World Financial Integration and Issues of Adapting the Romanian Policy to the Evolution of the Euro Exchange Rate within its Fundamentals", December 2002.

*This article was written in July 2003.

2 See the debate of the two famous economists in: Friedman, M. and Mundell, R. A. „One World, one Money?", Policy Options - Options Politiques 22(4) p. 10-30 May 2001 Canada.

3 See George M. von Furstenberg „One Region, One Money: Implications of Regional Currency Consolidation for Financial Services" Fordham University New York, Washington, D.C., 29 September 2001.

National currencies in a region would be merged into one currency to gain economies of scale and a market credibility that would come from an independent regional central bank, free from short-term political interference. Some observers find that, at global level, *„from an economic point of view, it would be preferable to retain … three or four currencies"* [4] . They take into consideration, at least, **the dollar, the euro and the yen.**

Global liberalization, regional economic integration, and a lengthening list of financial, e-commerce, and other activities eroded the monopoly of small currencies in their home market. Their **national currencies have been exposed to international competition** and have to struggle for survival. Small national currencies continued viability is threatened. There is greater urgency for their government policy to decide whether to hang on to a financially small and purely domestic currency in which less and less business can be conducted cost-effectively or to merge it into some form of currency consolidation or regional monetary union.

Among the three *major currencies* of the world, the U. S. dollar, the euro and the yen, there is probable *no better alternative* **to floating rate regime.** On the contrary, inside regional economic unions of the world have grown the pressure to take new steps to assure irrevocable fixed exchange rates. For the *smaller countries* in each region, the questions raised by financial liberalization are quite different. For them, maintaining separate volatile currencies became less desirable when exchange rates, instead of being serviceable shock absorbers, became a growing source of shocks to the domestic economy and its finance. Abrupt changes in nominal and real exchange rates that reverse themselves only after a currency crisis can drastically change competitive conditions between the members and of members with outsiders.

Such changes disturb rather than equilibrate trade relations. The desire to avoid such upsets by using a single currency inside economically integrated regions has contributed to a mutual insurance interest in European Economic and Monetary Union. Nevertheless, the adoption of euro owed more to the political logic of shared governance and a common anti-inflationary resolve than overwhelming pressures in financial markets. This may explain a part of the slow progress in the direction of a common regional currency in other great regions of the world, in the Americas with NAFTA and Mercosur, in East Asia or in Southern Africa.

2. Many options on the road towards the regional European currency

The euro is the first great success of a regional currency consolidation with a large potential in the international finance. More than *50 countries* outside the Euro area currently have an exchange rate regime involving an external anchor in which euro plays a role [5]. **Romania** needs to overcome many problems to get through the stages required for the euro monetary union. The problems range from standardizing the macro and micro economic policies and adjusting the

4 Kenneth Rogoff „Why not a global currency?" January 8, 2001 Economics Department, Littauer Center, Harvard University, Cambridge MA.
5 European Central Bank, Annual Report 2001, Frankfurt am Main, Germany.

business cycle in line with the business cycle of the Euro zone to putting on track the role and the functions of the national central bank according to the Euro system standards. Romania has to prepare to join the Exchange Rate Mechanism II (ERM II) and to meet the convergence criteria for euro zone. It must very seriously get prepared in a shorter period of time for the advantage of entering in the euro economic and monetary union and also for losing inter alias its national monetary policy and capital markets.

Within the European Union, **Economic and Monetary Union (EMU)** is the process whereby the economic and monetary policies of the member states of the Union are being harmonized with a view to the introduction of a single currency. It was the subject of one of the two Intergovernmental Conferences held in December 1990. The Treaty provides that EMU is to be achieved in *three stages:*

- First stage (1 July 1990 to 31 December 1993): free movement of capital between member states, closer coordination of economic policies and closer cooperation between central banks;
- Second stage (1 January 1994 to 31 December 1998): convergence of the economic and monetary policies of the member states (to ensure stability of prices and sound public finances);
- Third stage (from 1 January 1999): establishment of a European Central Bank, fixing of exchange rates and introduction of a single currency.

Eleven member states participated to the third stage of EMU that began on 1 January 1999. Two years later, on 1 January 2001 Greece joined them. Three member states have not adopted the single currency: **Denmark, Sweden,** and the **United Kingdom.**

To ensure that the sustainable convergence required for the achievement of economic and monetary union comes about, the Treaty sets **five convergence criteria,** which must be met by each member state before it can take part in the third stage of EMU. The Commission and the European Central Bank (ECB) draw up reports to check whether the criteria are being met. The criteria are:

- the ratio of government fiscal deficit to gross domestic product must not exceed 3%;
- the ratio of government debt to gross domestic product must not exceed 60%;
- there must be a sustainable degree of domestic price stability and an average inflation rate, observed over a period of one year before the examination, which does not exceed by more than 1.5 percentage points that of the three best performing member states in terms of price stability;
- there must be a long-term nominal interest rate which does not exceed by more than 2 percentage points that of the three best performing member states in terms of price stability;
- the normal fluctuation margin provided for by the exchange-rate mechanism (ERM II) on the European monetary system must have been observed without severe tensions for at least the last two years before the examination.

The convergence criteria, then, are meant

to ensure that economic development within EMU is balanced and does not give rise to any tensions between the member states. It must also be remembered that the criteria related to government deficit and government debt must continue to be met after the start of the third stage of EMU (1 January 1999). A stability pact with this end in view was adopted at the Amsterdam European Council in June 1997; the other three criteria are substituted by the unique monetary policy decided by the European Central Bank.

Romania and the other accession countries must meet the conditions of all three stages, as the initial 11 member states, and the convergence criteria. But which is the best approach for the national exchange rate regimes to go through these three stages since in the last two years the candidate currency has to stay in a band of fluctuation close to the euro? Does it mean that an intermediate exchange-rate regime is the best choice?

Romania's approach to the regional currency is *a common debate for all emerging- market economies,* including here also the transition countries, focusing on the type of the **exchange rate regimes.** In broad lines the exchange rate regimes, excluding multilateral regimes, may be divided in **two large categories:** „corner regimes" and intermediate regimes[6].

II. „Corner regimes" comprise:

- hard peg regimes consisting of
  a. currency board arrangements;
  b. the unilateral official adoption of a foreign currency e.g. dollarisation, euroisation or other currency substitution.
- Floating rate regimes consisting of independent floats and managed floats. In the former interventions are to smooth only the market movements and in the latter to influence only the direction of the change of the exchange rate.

II. Intermediate regimes (or soft peg regimes) are those under which the authorities aim to achieve a pre-announced or undeclared exchange rate target. This type comprises peg to other currencies or basket of currencies, crawling pegs, and bands of fluctuations.

3. The offensive of the advice for the corner regimes

Emerging market economies are frequently advised to adopt a „corner" exchange rate regime (in reference to floating rate and hard peg regimes at either end of the continuum of exchange rate regimes) in order to resolve the tensions resulting from these economies integrating into regional or global economy and finance. This advice takes into consideration that the crises in the late 1990s mostly affected countries with intermediate regimes (or „soft peg" regimes defined by default as the remainder from corner regimes). More over, the currency competition pressure means, first of all, at least theoretically, more national currencies pegged by major currencies of the world. More recently, because of stricter requirements imposed by hard peg regimes are considered acceptable only for a very limited number of countries, floating rate regimes (independent floats and managed floats) have been advocated over hard peg regimes, giving rise to double bias against

[6] See „Exchange Rate Regimes for Emerging Market Economies", European Central Bank, Monthly Bulletin February 2003, Frankfurt am Main, Germany.

intermediate regimes. But also the floating regimes are very demanding and, in its pure form, suit only a few emerging countries.

In fact, **the most appropriate exchange rate regime for a country depends on the characteristics of that country.** The theory of *„optimal currency areas"* considered important capital mobility, the inflation rate differential with major trading partners, the rise of the economy and its degree of openness, the geographic and product diversification of trade, labor mobility, the degree of synchronization of business cycle and the stage of economic development. Another strand of the literature considered that *the nature of shocks* (source, frequency and severity) was the major variable in regime choice.

A common, though not universal, conclusion is that floating rate regimes minimize the economic costs of shocks for the domestic economy and the global system. Support for this conclusion is theoretically derived from the *„inconsistent quartet"* which is the impossibility of having simultaneously openness to trade in goods and services, unrestricted capital flows, autonomy of monetary policy and a fixed exchange rate. Practically, **for small countries, a floating rate regime raises the negative impact of the shocks** because it requires at least a very sound domestic financial system.

The trend towards increasing economic openness has heightened the importance of the exchange rate regime in the price formation mechanism. For small, open economies, the variability of the exchange rate is of greater concern than for the large more closed economies.

Of the *additional criteria* identified as relevant to regime choice the most pertinent include the degree of regional economic (cyclical and structural convergence) and institutional integration, the depth of financial and foreign exchange markets and the level of international reserves.

Where present, *regional co-operation* may significantly alter the cost-benefit considerations in regime choice and affect the modalities of regime shifts.

In order to prepare for *the membership of the exchange rate mechanism* (ERM II) of the EMU, some European Union accession countries are moving through various types of regimes with ultimate shift being the adoption of the single currency. **Romania** has started with a fixed exchange rate regime and moved gradually from an intermediate (soft peg) regime to a managed floating regime. Now the national currency has **a managed floating exchange rate** against a basket composed 60% of euro and 40% of U.S. dollar. **Bulgaria** has started also with a fixed exchange rate regime and moved gradually from an intermediate (soft peg) regime *to a currency board pegged to euro.* At the other end, only **Poland** has adopted *an independent floating exchange rate,* but with two anchors for its monetary policy, one internal and the other an external one.

Regional integration and co-operation is an issue which confronts other regions such as **East Asia, North and South America** and **Southern Africa**, where the desire to stabilize intra-regional exchange rates to foster trade and capital flows may necessitate reducing volatility and uncertainty in exchange rate movements between integrating countries. Such an objective **is theoretically more comparable to some form of fixed rate**

regime than a freely floating regime. This makes the choice of an exchange rate regime even harder. The considerations behind regime choice show that, since economies differ widely and evolve through time, no single exchange rate regime will be suitable for all countries until it enters into a monetary union.

The evolution of the policy framework of a country is an *interactive process*: while the exchange-rate regime must be tailored to suit the other policies, it will in turn influence them. This two-way, dynamic interaction is significant on two counts. First, no exchange rate regime per se constitutes an intrinsic guarantee for macroeconomic and financial stability.

Second, the exchange rate regimes have a disciplining effect on other policies. The degree of this disciplining effect is determined by both the choice of an external or internal anchor for monetary policy and by the degree of the control of capital flows. With an external anchor, under hard peg regimes and, to a lesser extent, under the intermediate regimes, the country seeks to import credibility at the cost of restricting its degree of monetary policy freedom. By contrast, under floating rate arrangements, the commitment to the internal anchor forms the basis for policy discipline and determines the credibility of the regime. This latter credibility relies on the *high quality of domestic institutional and operational requirements*. Such requirements apply first to monetary policy and its transmission mechanism (e.g. central bank independence, accountability and transparency, and domestic capital market deepening) but also to the other components of the domestic policy framework (e. g. fiscal and financial policy). The majority of accession countries to EU chose to prepare for the ERM II membership with an internal anchor. Only a few choose a regime with an external anchor e.g. Estonia, Lithuania and Bulgaria.

4. Some benefits and costs of the different type of exchange rate regimes. The currency consolidation through adoption of a hard peg regime may be not a good solution.

Each exchange rate regime type has advantages and major costs and implies certain factors pending to stability. In general, the advantages of the fixed rate regimes refer, firstly, to reducing transaction costs and exchange rate risks and real volatility, which in turn encourage trade and investment and, secondly, to providing an external anchor.

Under *currency board arrangements,* monetary authorities pledge to sell foreign currency for domestic currency on demand at a fixed rate, and back the domestic currency entirely with foreign currency for this purpose. *Official dollarisation* (or *euroisation*) does not permit a mismatch in the currency denomination of assets and liabilities in the public, banking, corporate or household sector, thereby eliminating the risk of a related run on banks. On this count, currency substitution does not require the same degree of strength of the banking sector that is necessary under currency board. But, the official currency substitution requires the political willingness inter alia to abandon the domestic currency, and concomitantly the

seigniorage revenues, which are not insignificant (may be estimated at 3% of GDP).

Another big problem both for the currency board and currency substitutions is *the absence of the domestic monetary policy*. Since hard pegs involve a commitment to an unadjustable exchange rate, the authorities must give up of monetary policy autonomy and pursue appropriate fiscal, structural and financial policies to currency adopted. This requires tough fiscal and financial discipline, price flexibility and the availability of an adequate level of international foreign reserve to operate effectively, since the exchange rate cannot be used as a shock absorber. Under hard peg regimes, the domestic economy seems to be left without any protection, *exposed to all kind of shocks.*

These regimes are employed by countries where the capabilities to conduct an alternative exchange rate or domestically anchored monetary policy are impaired by institutional and operational constrains. At present, in the world there are fewer countries willing the *official currency substitution* with dollars or euros (e.g. **Panama, El Salvador and Ecuador**) or to pursuit *currency boards* (e.g. **Hong Kong, Estonia, Lithuania and Bulgaria**).

It should be added that, although *no European Union accession country chose an official currency substitution* (e.g. dollarisation or euroisation), **all are registering an *involuntary currency substitution.*** The degree to which the financial system is *de facto* dollarized (or euroized) depends largely on relative volatility of the inflation rate (more volatility makes foreign currency deposits less risky) and of the real exchange rate (more volatility makes foreign currency deposits less risky in terms of domestic prices).

In all kinds of fixed rate regimes, since the exchange rate cannot be used as a shock absorber, *wages and prices must bear directly the burden of adjustment.* Given that, in principle, *the central bank is not in the position to play the role of lender of last resort,* the authorities cannot support any individual institution or the banking sector in a systemic crisis. As a result, a *precondition* for the adoption of a hard peg regime is the existence of a sound domestic financial sector, which partially may be offset by a significant presence of foreign banks, a sound economic policy and a continuity of financial foreign inflow into domestic market. The success of a fixed rate regime depends widely on the country characteristics.

Even within the same type of exchange rate regime the *conditions are very different.* For instance, **Argentina**'s currency board arrangement had little in common with **Hong Kong**'s currency board arrangement. On the other hand, a currency board arrangement *that pegs unnaturally* to a currency from outside the country's major trading region is prone to stress. **Singapore**'s shift in 1967 to the U.S. dollar-based currency board, from a sterling-based one, though precipitated by the desire to disassociate from the sharp pound's devaluation from 2,8 to 2,4 dollars per pound, was appropriate to its trade and finance as well. Singapore broadened its exchange rate reference further a few years later when it made the transition to managed floating.

By contrast, **Lithuania**'s insistence on maintaining a dollar-based currency board in what is rapidly becoming a sea of euros has been costly and the economy fell into a recession as long as the strength of the dollar against euro persisted up to 2002. Then, Lithuania switched to euro-based peg on 2 February 2002, but unlucky again because the euro begun to appreciate sharply thereafter. In general, ***currency boards*** established in distant outposts far away from the „peg country" and its currency area, however, **represent *a false start from the point of view of currency consolidation.***

Even a currency board with the dominant currency next door may often not survive for long when its financial system is exposed to direct competition from its more experienced neighbor. *The strength of trade and financial relations of countries in the vicinity of the euro zone makes the almost complete financial integration and interest rate convergence that is available upon formally adopting the euro more attractive than stay in a half-way house of a currency board.* Hence not only for **Central and East European countries** but also for every emerging country ***if currency consolidation*** is to be allowed, some form of ***monetary union is the best way*** to achieve it. Of course, different kinds of monetary union have different kinds of advantages and costs. The multilateral and co-managed euro zone is just one of them.

Unlike hard pegs, **floating exchange rate regimes** permit the pursuit of an *autonomous monetary policy* to absorb the external shocks. On the *advantages,* first, such a policy is consistent with the prioritization of domestic objectives, as may be inflation. Second, with no implicit exchange rate guarantee, the scope for moral hazard is reduced. Third, exchange rate flexibility should allow for smoother and gradual adjustment to external shocks than intermediate regimes and hard pegs. Forth, floating regimes are relatively less crisis-prone. They are better able to cope with abrupt capital flow reversal.

On *downside,* first, it should be noted that the monetary policy of a small country is either illusory or undesirable in certain cases (a country subject to spillover effects from other economy, for example). Optimal currency area theory suggests that small, open economies *may be better off being part of a larger monetary area* rather than having their own independent currency. Second, owing in part to the difficulty of many emerging markets in issuing debt in domestic currencies, foreign currency indebtedness is *vulnerable* to downward pressure in foreign exchange market and the flexibility of the exchange rate is of no advantage.

Third, an internal monetary anchor, absolutely needed, is problematical in the form of *a money target* because of instability of money demand and under-developed domestic capital market. *Inflation targeting is a more viable choice,* but is not enough. It implies *specific requirements,* central bank independence and transparency, a high quality of monetary policy transmission mechanism and a developed domestic financial system, insofar as financial variables are used to measure market expectations.

Because, in emerging markets, some elements of the inflation target framework are lacking, it tends to be complemented to some degree of *exchange rate targeting.*

That means *a dual pursuit of an internal and external anchor for the monetary policy,* recently and successfully experienced in some countries like **Israel, Chile, Mexico and Brazil.**

The analyses of **intermediate regimes,** particularly those with a *pre-announced exchange rate target,* first, suggest that careful management of the exchange rate is necessary to secure credibility and minimize vulnerability to crisis.

Second, under the *intermediate regimes with conventional fixed-rate,* because of the „inconsistent quartet" of free trade, a fixed exchange rate, unrestricted capital flows and the autonomy of monetary policy, the monetary policy has little room for maneuver and is subordinated to maintain the exchange rate. In effect, this *means adopting the monetary policy of the anchor currency country,* which can cause economic strain if the two countries' *business cycles* are not synchronized.

This is the case also with some candidate countries preparing for the *euro zone.* In countries pursuing a disinflation policy, the positive interest rate differential maintained to reduce inflation induces capital inflows, which must be sterilized in the foreign exchange market, and this can be costly (estimated at 1% of GDP per annum).

Third, rising capital flows accompanying capital account liberalization make *intermediate regimes vulnerable to crises* of the East Asian type of late 1990s. To the extent that economic agents feel protected by implicit exchange rate guarantee, this may foster *moral hazard.* In the event of a crisis, *costs may be high* and are incurred whether the exchange rate is defended or abandoned.

5. Romania's exchange rate benchmarks in a dual target of the monetary policy

The exchange rate is currently the main intermediate target of Romania's monetary policy. Since early 1999 the central bank, i.e. the National Bank of Romania (NBR) has generally pursued a dual target of **gradual disinflation** on one hand and of sustainable external position by using the **exchange rate as a soft nominal anchor** on the other hand. NBR shifted the emphasis between „soft" and „anchor" as dictated by the relative importance of the two sides of the target at each particular moment.

Although this framework proved later good, it didn't work all the time due to inconsistencies in the monetary policy that is shared between NBR and ministry of finance. It has performed relatively well, especially since late 2001, when fiscal and wage policies got largely harmonized with a tight monetary policy in pursuing the stabilization objectives of internal and external equilibrium. Thus, inflation fell from 55 percent at the end of 1999 to about 15 percent in mid-2003 while the current account deficit has been sustainable and gross international reserves have steadily accumulated.

As in many emerging countries, in Romania **domestic prices and exchange rate move together. Since central bank plans to adopt fully fledged inflation target by the end of 2004** quantifying how much of and how fast the exchange rate depreciation turns into inflation has become very important for formulating monetary policy decision.

During 1997-2002, the **exchange rate**

pass-through to both consumer and producer prices has been relatively large and fast, ranging between 60-70 percent for producer prices and 30-40 percent for consumer prices, depending of the choice of the exchange rate benchmark. Most of this effect has been felt after 12-15 months[7]. Romania's relying on exchange rate for disinflation has **apparently had no alternative** since such a lag of time is considered too short for monetary policy to affect inflation via the interest rate or the credit channel.

The choice of an exchange rate benchmark for targeting could be an important policy issue for Romania if it turns out that **the pass-through differs between the benchmarks.** Historically, the NBR has used the exchange rate against the U.S. dollar (Lei/US$) for the targeting of the monetary policy.

However, as preparing the transition to the European regional currency and after switching to targeting a 60/40 Euro/US$ basket in June 2002, the NBR is considering **the use of the exchange rate against the euro (Lei/Euro) as its intermediate target in the near future.** The exchange rate of the Leu in terms of the basket (60/40 Euro/US$) is currently very close to the nominal effective exchange rate, as the bulk of Romania's foreign trade is conducted either in euro or U.S. dollars. The flows in euro account for more than 60 percent of exports and more than 5o percent of imports.

Until recently the pass-through from Lei/U.S. dollar exchange rate used to be larger, if not faster than the pass-through from the Lei/Euro one, with the basket understandable in between. This difference may be explained by **the higher weight of U.S. dollar pricing in Romania's imports of intermediate inputs.** Intermediate inputs constitute a large part, about 60 percent of the overall Romanian imports. While the trade flows in U.S. dollars is estimated at about one third of total trade, it is exceeding 50 percent in imports of intermediate inputs.

In a high-inflation environment, domestic price setting reflects expectations about future exchange rate dynamics as a proxy for expected inflation. At current lower levels of inflation (and especially when it falls to single digits), the **signaling role of the exchange rate for future inflation declines** and therefore this channel of pass-through decreases in significance. Given the Romania's economic profile, as long as the exchange rate is the nominal anchor, the dollar should be represented in the targeted benchmark.

The contribution of estimated Lei/US$ exchange rate shocks to domestic inflation turns sharply negative in mid-2002, as a result of NBR adopting the 60/40 Euro/US$ basket as a targeted benchmark. With steadily appreciation of the euro throughout 2002 and thereafter, the Lei/US$ exchange rate trend moved from upward sloping to a flat line.

This policy change, which amounted to effective monetary tightening, may be responsible for the significant over-performance of inflation in 2002 (an outcome of 18 percent versus a target of 22 percent).

7 Nicolay Guerguiev, "Exchange Rate Pass-Through in Romania", June 2003, International Monetary Fund, European I Department, Working Paper WP/03/130.

6. The shift from preponderance of intermediate regimes to floating regimes

In emerging market countries there is a *distinction* between *de jure* regimes (declared to the **International Monetary Fond**) and *de facto* regimes. Over a half of all declared regimes are not actually pursued. This discrepancy can be explained, to a large extend, by emerging market countries „fear of floating" and, to a lesser extend, „fear of fixing".

„Fear of floating" is the fear that a falling exchange rate will raise inflation and/or cause a large rise in debt denominated in/or indexed to a foreign currency. *„Fear of fixing"* is a dual fear. It is the fear of becoming the target of a speculative attack if a peg to a given exchange rate is declared. It is also the fear that, for relatively closed economies operating a fixed rate regime, a sudden stop in foreign capital inflows will necessitate a very large real depreciation of the exchange rate. This depreciation is needed to restore a viable external position and it implies a degree of prices and wages flexibility which is both difficult to achieve and politically unacceptable.

Also the *distinction between various type* of corner and intermediate regimes pursued is not clear. For instance, at the flexible end of corner regimes, the motive of managed floating is to influence the direction of change in the exchange rate; the motive of independent floating is to reduce volatility. But, these motives can be identified, if at all, only after intervention.

In general, the analyses in emerging countries suggested that *intermediate rate regimes are currently the second most popular type of regimes, behind the floating rate regimes,* but well ahead of hard peg regimes. This compared with the observation that in the year 1990 almost four-fifths of emerging-market economies pursued intermediate regimes.

Nevertheless, claims of growing preference for corner regimes after the Asian crisis of late 1990s are exaggerated. Of the emerging market countries exited intermediate regimes, more than half adopted another form of intermediate regime rather than corner regimes.

Shifts to a floating rate regime could not be described as a free choice but are rather favored by a lack of credible alternatives. The number of emerging countries with *de facto independent floating rate regimes is rather limited.* Also only *a small number of countries have pursued hard pegs* for any significant period of time (e.g. **Panama, Hong Kong and Estonia**), while the bad experience in **Argentina** showed how demanding are the conditions to sustain a currency board.

At the opposite end, experiences in countries like **Brazil** and **Poland** with independent floats are too recent as to draw firm conclusions. For emerging-market economies the floating regimes are very demanding because of institutional and operational requirements needed to operate this type of policy framework in a credible manner. For this reason, the floating regimes in emerging countries *are mostly managed floating regimes.*

Since economic and financial conditions vary widely across countries, **there is no ideal exchange rate regime for all countries, no for any country all the time.** Consequently, EU accession

countries should *pay attention to the full range of regimes* available and make a choice in accordance with their own particular situation. They *must take into account* the degree of monetary policy autonomy, desirable and feasible, the degree of capital account liberalization and financial stability, the pattern of trade and financial linkages and the road map of regional integration. An exchange rate regime is not an end in itself, but a means to macroeconomic stability and sound and sustainable growth.