Abstract

This paper suggests that the practical operation of the European Exchange Rate Mechanism (ERM) provides important lessons for authorities in developing countries struggling to implement sustainable exchange rate regimes to support economic convergence. These lessons are beginning to spread beyond the European continent, reaching in particular Argentina and Brazil. The difficulty in adapting a code of conduct like that of the ERM in Latin America is certain to be greater given the absence of financial reputation in either one of the two main members of Mercosul and the novelty of peer pressure among them. The “Eurocentric” tale this paper tells about Argentinian and Brazilian risk posits that the decoupling visible since 2001 could be sustained by enhanced regional surveillance in the Mercosul if financial reputation in its two main members were sufficient. While this tale is for the long term, it provides an anchor for the difficult choices Argentina and Brazil face in trying to earn credibility abroad.

1 Introduction

Regional surveillance mechanisms may alleviate investors’ reluctance to trade assets outside well-established risks. At the heart of the transition to a single European currency (1989–1999) is a shared code of conduct and an institutional architecture where currencies floated in order to fix. This experience with earning rather than importing policy credibility is relevant to emerging markets, even if initial conditions are different as long as there is willingness and ability to carry out structural reforms. As it turns out, fears of diverging European transitions have proven mistaken with respect to nearly all the candidate countries, even though reforms have been carried out at different speeds, and there have been instances of backtracking.

Remark: We are grateful to an anonymous referee for comments. Helmut Reisen, a former Kiel economist whose friendship we both treasure, was actively involved in related work carried out at the OECD Development Centre. Nevertheless, remaining errors or shortcomings are ours alone.
The adoption of appropriate policies and the ability to sustain institutional changes has been more important than initial and terminal conditions. Among the various issues of policy and institutional reform, how to deal with the fall in interest rates that goes alongside the process of reputation building is perhaps the most obvious in the context of the Eurosystem. In emerging markets, this “interest rate free ride” is subject to stronger reversals, so that its benefits for individuals and firms may be elusive. The absence of a credible nominal anchor is certainly a factor in that expected depreciation enters in the forward discount but there is also the perception that political governance is and will remain inadequate at the national and regional level. As a consequence, residual devaluation fears are likely to remain for a long time even under perceived hard pegs—and end up being validated by events, making countries victims of the “euro holdup.” The “Eurocentric” tale told here about Argentina and Brazil suggests that the decoupling in interest rate spreads visible since 2001 could be sustained by enhanced regional surveillance in the Mercosul if financial reputation in its two main members were sufficient. The apparent success of the Chang Mai Initiative involving the members of ASEAN plus China, Japan, and Korea goes in the same direction (Langhammer 2001, 2002).

This paper is organized as follows. The next section introduces the group dimension in the choice of the exchange rate regime and argues that regional surveillance helps countries earn credibility through the operation of a shared monetary and fiscal code of conduct. Further, section 3 embeds effective multilateral surveillance in flexible integration schemes, whose potential benefits for European institutional architecture can also be reaped outside Europe if countries manage to earn credibility in this way. Section 4 focuses on limiting crisis vulnerability in Argentina and Brazil. It questions the “political noise” explanation of the changes in country risk in Brazil after the Argentine default by focusing on the financial contagion determinants of the pure default premium. The conclusion recognizes the diversity of paths in the transition to the euro and in the effects the single currency has had on structural reforms, not least in budgetary procedures, stressing the cautionary nature of the “Eurocentric” tale.

2 Earning Credibility through Regional Surveillance

Regional integration reinforces peer alignment, contributing to the atmosphere in which peer review and surveillance take place. The EU and euro area policy review processes are very intensive, with peer pressure based on elements that cannot be replicated in any looser form of international institution. There are elaborate, frequent procedures sometimes based on rules, but mostly on national