Chapter 13

Exchange Rate Overvaluation and Currency Crises: Lessons from Latin America and East Asia

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1. Introduction

In the aftermath of the currency crises of the 1990s there has been widespread discussion on the need to create a "new financial architecture." The debate has been largely centered on grand schemes, such as the creation of a global lender of last resort, and the reform of some of the multilateral institutions, including the International Monetary Fund (IMF). Much of the official discussion has rapidly become highly bureaucratized, focusing on formal procedures. In fact, in my view, one of the most interesting aspects of the 1999 Federal Reserve Bank of Chicago–Bank of International Settlements conference on “Lessons from Recent Global Financial Crises,” was the emphasis placed by so many participants on formality. Many, if not most, of the issues addressed revolved around questions such as: Which international committee has the authority to do what? When are the deputies getting together? How will the agenda be determined? This emphasis on formality is particularly frustrating to the emerging countries. After all, they rarely participate in the key committees, and are almost never consulted on the key reforms.

At the end, when everything is said and done, it is likely that very little will happen in terms of major global reforms: the IMF will continue to be the IMF, there will be no global lender of last resort, the international bureaucracy will continue to swell, moral hazard will still be a serious problem, and crises will erupt from time to time. What we are likely to see, however, are important changes at the level of individual country’s policies. This trend will be particularly pronounced in the emerging countries, where we are likely to see changes in: 1) policies affecting
capital mobility; and 2) exchange rate policies. More specifically, we will see more and more countries adopting some form of controls on capital inflows, possibly similar to those imposed by Chile during 1991–98. Also, an increasing number of countries will move to extreme exchange rate arrangements, adopting either floating rates or some form of strong rigidity, such as currency boards or full dollarization. A key policy question, and one for which we still have no clear answer, is whether a particular combination of exchange rate and capital control policies will reduce an emerging countries’ vulnerability to external shocks and “contagion.”

In this paper, I discuss the way in which thinking regarding exchange policy has evolved in the post crises period. In the discussion, I make the point that, possibly, the most important lesson from these crises is that emerging countries should make a major effort to avoid real exchange rate overvaluation. The problem, however, is that current methods for evaluating whether a particular country’s currency is overvalued are subject to serious limitations. I argue that improving on our understanding of real exchange rate behavior is a fundamental step in any effort on improving our capacity for crisis prevention.

2. Crisis, Contagion, and Exchange Rates

In the late 1980s and early 1990s, and after a period of relative disfavor, rigid exchange rates made a comeback in policy and academic circles. A number of authors argued that fixed, or predetermined, nominal exchange rates provided an effective device for guiding a disinflation program and maintaining macroeconomic stability. According to this view, a prerequisite for a successful exchange rate-based stabilization program, is that the country in question has its public finances in order. Mexico had done this as early as 1988, the year that exchange rate-based stabilization program known as the Pacto de Solidaridad was implemented in full force.

However, recurrent problem with exchange rate-based stabilization programs—and one that affected the countries of the South American cone during the early 1980s—is that inflation tends to have a considerable degree of inertia. That is, domestic prices and wages will continue to increase even after the nominal exchange rate has been fixed. This, in turn, will result in a decline in exports’ competitiveness, as domestic costs will rise at a faster pace than proceeds from exports. Eventually, as was the case in Mexico between 1988 and 1994, this perverse dynamics will generate a serious degree of real exchange rate overvaluation, a slowdown in exports, and a very large current account deficit. Dornbusch (1997, p. 131) made this point forcefully within the context of the Mexican crisis:

Exchange rate-based stabilization goes through three phases: The first one is very useful. ... [E]xchange rate stabilization helps bring under way a stabilization. ... In the second phase increasing real appreciation becomes apparent, it is increasingly recognized, but it is inconvenient to do something. ... Finally, in the third phase, it is too late to do something. Real appreciation has come to a point where a major devaluation is necessary. But the politics will not allow that. Some more time is spent in denial, and then—sometime—enough bad news pile up to cause the crash.