EXCHANGE RATE CHOICES: DISCUSSION

Takatoshi Ito*

Richard Cooper has provided us with an excellent overview of questions related to the exchange rate regime. His paper reviews the history of both exchange rate arrangements and exchange rate theories, in addition to discussing current issues; he also gives us a vision for the future. The paper presents a balanced view on the question of fixed versus floating exchange rate regimes, and it points out the dual role of the exchange rate with regard to current account transactions and capital account transactions. However, I sense that Cooper is probably more sympathetic to some kind of fixed exchange rate target zone than are many of his colleagues.

I like Cooper's paper; it covers a long history and wide geographical areas. I especially appreciate his care in distinguishing problems of developing countries and of advanced countries, and his pragmatic, as opposed to dogmatic, views about the problems of capital flows.

TWO-CORNER SOLUTIONS

As dust from the Asian currency crisis settled, the "two-corner solution" view emerged: A country can have either a currency-board arrangement (or dollarization) or a free-floating exchange rate system. This view was prompted by a series of crises among countries with fixed exchange rates but no currency board, Thailand, Indonesia, Korea, Russia, and Brazil, on the one hand, and by the resilience of economies with currency boards, Hong Kong and Argentina, on the other hand. Now dollarization is talked about in Argentina and Mexico. The two-

*Professor, Institute of Economic Research, Hitotsubashi University.

corner solution view achieved prominence in discussions about the international monetary system when Treasury Secretary Rubin suggested not only that developing countries would be well advised to adopt flexible exchange rates but also that they should generally not receive large-scale IMF financial support if they were defending an unsustainable peg.

Cooper does not appear to embrace the two-corner solution. In particular, he seems to be skeptical about the desirability and feasibility of the "free-floating exchange rate arrangement," at least for developing countries. As he explains in his paper:

> The core problem is that for economies with imperfectly developed financial markets the exchange rate is the most important asset price, and it will be jerked around by changes in portfolio sentiments. But for an open economy the exchange rate is also the most important price in the market for goods and services. Jumping asset prices can badly disrupt the markets on which the economic well-being of the majority of residents depends. . . . Furthermore, it is an open question whether a broad, diversified financial market based on the domestic currency can develop under floating exchange rates.

This statement reveals his concerns about the real-side impact of exchange rates increasingly determined by financial markets. However, Cooper does not go one further step into a "middle ground." He does not give an explicit answer to his own question, "What should developing countries do?" He says, "The choice is not easy." I would like to press him to explore the middle ground.

Would Cooper agree with the following statement? A developing country may be advised to pursue a fixed exchange rate with capital controls during the phase in which the country develops domestic financial markets and financial supervision. Capital liberalization will start with foreign direct investment (FDI) and then proceed to equities, long bonds, and last to short-term portfolio flows. A usual objection to capital controls is that they will kill the beneficial aspect of capital flows. However, Asian countries had high rates of domestic saving, and any additional benefits from capital inflows must have been small. Why would investment at the rate of 40 percent of GDP—with capital inflows equal to 10 percent of GDP—be better than that at 30 percent of GDP?

In the literature, we make a distinction between FDI and short-term capital flows. This distinction is not mentioned in Cooper's paper. Perhaps such a distinction would put a wedge between the real and the financial market forces that impinge on the exchange rate.

A Common Currency

The current arrangement of free-floating exchange rates among the currencies of the advanced countries—the United States dollar, the

Japanese yen, the euro, the British pound, the Canadian and Australian dollars—shows no sign of changing. Cooper devotes a substantial part of his discussion to the various views on the currency arrangements for these major currencies: floating, a target zone with a wide or narrow band, targeting monetary policy on the same (wholesale) price index, and a common currency for the world.

I sense that Cooper still envisions that a common currency for the world, which he advocated earlier, may be a good idea. He is modest but still visionary. "The suggestion was not politically realistic in the mid 1980s and is not politically realistic today, but it is set as a vision for a decade or two into the twenty-first century. The Europeans, in creating EMU, have taken a major step in the direction indicated. The idea could be taken further."

I wonder what the scenario of transition will be. There seem to be two different paths to the Napoleon III–Cooper kind of world. The first path is to fix (or provide a narrow target zone for) the rates among the major currencies, and then developing countries will follow. The second option is that the three currencies become regional currencies first and then link among themselves.

The first option does not appear to be put forward much in the world, despite calls from McKinnon and Bergsten for a target zone. For example, the number of yen per dollar went from 120 in 1993 to 80 in April 1995, and then from 80 to 150 in 1998. Cooper wonders whether Japanese firms diversify their production facilities around the world to avoid the impact of such currency fluctuations. I would say yes, and that the resilience of Japanese corporations to the yen/dollar rate volatility has increased. Therefore, the business–political push toward a target zone is weaker now than the mid 1980s, at least in Japan.

Let us explore the second path. What would be the scenario in 20 years? It is frequently said that Latin American countries may dollarize. The North and South Americas will become a dollar zone. The United Kingdom, Norway, Sweden, and the central European countries may adopt the euro. Euroland may extend from Portugal to Russia, even to Africa. Such regional developments seem to have a positive probability.

What about Asia? Asia may become a region where countries adopt a basket system in which the yen, the yuan, the euro, and the dollar are weighted—a step toward a common currency. Or perhaps Asian countries will be divided into two groups of countries, a euro group and a dollar group, leaving the yen as a very local currency. Or could the yen disappear from circulation to a showcase in a currency museum? How Asia will turn out is a most interesting question. A regional scenario for Asia is much murkier than the ones for other regions.

I would like to see Cooper develop his scenario of the transition to the common currency.