

An Institutional Analysis of Some Monetary Issues in Developing Economies

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Abstract

The paper shows the difficulties that the increasing international mobility of capitals set to the execution of monetary policy in the development countries. In modern capitalist economies, more than ever, money should be viewed as an institution. Therefore, it is first necessary to understand what are institutions (being money one of them) in order to comprehend the institutional and theoretical prerequisites to monetary policies and monetary stability. In this discussion, we emphasize the challenges that the monetary and financial opening up of many national markets impose for the execution of economic policies. In this sense, we also examine some of the specific institutional prerequisites to monetary stability in the development countries, because of facts as the inconvertibility of their currencies, and the frequent inconsistency of their fiscal, monetary and exchange policies, etc. We try to demonstrate that those institutional difficulties are responsible for the growing appeal of proposals to a complete abandonment of some national currencies, or for the adoption of currency boards in which the policymakers renounce to their power to decide about the liquidity level of their economies, in spite of the formal existence of their national currencies. Finally, we present some suggestions to the solution of the referred problems.

1. Introduction

At the end of the 50s, when the main countries of Europe gradually started to promote the return of their currencies to convertibility, after gathering important exchange reserves in dollars, the world began the trail back to the point where flows of international financial capital might regain their former pre-war importance in the international economy (Grabbe, 1996). The development of the Euromarket in the following years reinforced and accelerated the trend (Helleiner, 1996), culminating, in the beginning of the 70s, with the dismantling of the exchange rules established in Bretton Woods. After the first movements in this direction made by the United States and the United Kingdom in

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1971-73, several countries began to liberalise their finance systems, whether on a strictly domestic level or in terms of the flows in their capital account (Williamson & Mahar, 1998). From that moment on, a similar tendency for an opening up of the financial systems spread over the world, arriving at the developing economies in the end of the 80s. As a matter of fact, in the 90s, the world economy achieved a level of mobility in international financial capital not seen since the beginning of the twentieth century (Obstfeld, 1998).

One of the most visible effects of this process directly affected the degrees of freedom the countries have at their disposal to conduct economic policies for the achievement of internal goals. New conditions, including institutional ones, were imposed on the implementation of monetary, fiscal, and exchange policies. However, several economic analyses are still made under the presumption that we are living in closed economies. Such a stance is more readily noticeable in the literature that deals with monetary policy issues (Svensson, 1998).

At best, some models are developed in which the domestic interest rates are conditioned by the international ones and by expectations (defined almost invariably according to the canons of the rational expectations hypothesis) in relation to the exchange rate, and in which the national economies are subject to shocks which have their point of origin "elsewhere in the world". Furthermore, there are few discussions over the nature of national currencies in this open economies scenario, global finances and portfolios made up of different currencies. More than ever, the national currencies are seen as institutions under continuous evaluation by the markets (which are increasingly constituted, as explained before, by agents whose portfolios are made up of many different currencies) in terms of the ability of these institutions to clear debt contracts, that is, to show themselves as assets with great liquidity, not only in the national arenas but also in the international one.

This paper investigates the difficulties which such restrictions impose over the monetary policies in the developing countries. In the next section we discuss currencies as institutions. In the third part, we show the obstacles to the implementation of monetary policies in open economies. In the fourth section, the preconditions of currency stability are presented and, in the section that follows, we explain which are the institutional prerequisites necessary in order that these preconditions of stability are attained in the developing countries. In the sixth part, we analyse the proposals to jettison some national currencies or to adopt currency boards. Finally, we draw some brief conclusions, presenting some proposals for the solution of some important problems analysed in the paper.

2. Money as an Institution

Institutions are defined as rules and patterns of behaviour or interaction among people verified in one (or part of a) society, rules and patterns of behaviour which must acquire some stability, i.e., need to be repeated, even for a short time span. That is, institutions set up and, at the same time, restrict, the choices of individuals, at least in terms of what is socially recognised or considered acceptable and/or rational. Of course this does

not mean that these individuals must be conscious of these norms and rules, or of their meaning or function.¹ Institutions reflect and, at the same time, settle, the value structure of societies.² And, therefore, they prescribe the expected behaviour and performance of some social functions and situations, and also determine – together with some ways of rewarding and creating incentives,³ and with sanctions against deviating behaviours – the motivations⁴ for and the level of confidence that one can have in this behaviour and performance.

So, institutions can have an important role as a means of reducing uncertainty, through the coordination of formerly divergent expectations of some agents and the concentration of these expectations in certain ranges (Simon, 1991:39; North, 1990; 1991). For divergent expectations emerge more easily when some laws, norms and rules (formalised or not, and which reduce the possible range of behaviours of the agents) are not established, and thus a high level of confidence does not prevail.⁵ Undoubtedly these are some of the classical problems analysed by Keynes (1936:148-9; 1937), that is, those concerning uncertainty and the state of confidence, with institutions in their role of "uncertainty reducers" contributing immensely to diminish "the likelihood of our best forecast turning out quite wrong." (Keynes, 1936:148).

1 Hall (1986:19); Elster (1989:99). Elster shows that social norms need to be shared by some (or many) people. Johnson (1992:26) includes among institutions the habits, routines, rules, norms and laws, as well as the organisations. I include communication between people in these patterns and rules of behaviour and interaction: As explained by Tool (1990:166): "Socially correlated patterns of behaviour are internalised by individuals and become habitual. Institutions, then, are made up of habits but they are not determined by habits. Being constituted of habits, institutions are often resistant to change. Rules, codes, customs, and attitudes, once established and embedded as habits, define expected behaviour and are presumed to be continuing." See also North (1990:4; 1991; 1994); Landesmann & Pagano (1994:199); Langlois (1986a:17; 1986b); Akerlof (1976:24) and Popper (1963:149-52).

2 Tool (1990:166). See also DiMaggio & Powell (1991a) for the visions and importance of values for Parsons and Bourdieu. For these authors, values are set before institutionalisation, i.e., they are preconditions to institutionalisation.

3 Popper (1963:156); Rizzo (1985:881-2); Elster (1989:99-100). That is why I prefer to define institutions as patterns of behaviour and not as rules which define or impose them, as, for instance, in North (1990:3). For rewards, despite the fact that they may be established by rules (at least in the majority of cases), can hardly be seen as restrictions.

4 Granovetter (1985); North (1990; 1991). In this definition of institutions I do not include ideologies, as, for instance, in Veblen (1899:110), or in some other important contemporary institutionalists (Friedland & Alford, 1991:243; Johnson, 1992:27-8). This does not mean that "mental habits" or the ideas of different individuals do not acquire some stability and routine characteristics — historically, culturally or personally determined — which cannot be included in a definition of institutions. The objection is to overburden this concept with the one of ideology, for ideologies, in spite of some collective aspects that they hold, have a marked individual nature, which escape the definition of institutions presented before. I define ideology as the way through which a person tries to explain "the world" as a whole, understood as everything which enters his/her field of perception, or on which he/she reflects (in this case it can surely also include things that do not exist). In a similar sense, cf. North (1990:16-23,137-8) and Fligstein (1991). See also Vasconcelos et alii (1999).

5 Therefore, institutional stability reduces uncertainty, through the narrowing of the range of expected actions in particular situations (Dopfer, 1991). It can also provide, as Lundvall (1992a:10) underline, "guide-posts for change. In this context, we may regard technological trajectories and paradigms which focus the innovative activities of scientists, engineers, and technicians, as one special kind of institution." Johnson (1988) also emphasizes the trade-off between the institutional flexibility and the function of institutions as guide-posts.

Institutions can be formal — as, for example, written rules and laws — as well as informal — as in the case of conventions, behaviours and codes of conduct.⁶ According to North (1990:46), this distinction is only a matter of degree, which could perhaps be represented by a *continuum* that would go from taboos, customs and traditions — on the informal side — to constitutions, laws and written rules — on the formal one.

In this sense, as Keynes already recognised in *The General Theory* (Wray 1998), the various national currencies can easily be perceived as institutions,⁷ for nowadays they are nothing more than mere symbols of value, since they possess no legal correlation with any material which possesses an intrinsic value, as they did formerly, at least in theory. However, even when paper-money represented metal values, we were still dealing with institutions, because this money (paper) represented nothing more than a contract which guaranteed the bearer that he (she) would receive a specified quantity of metal which represented determined values in paper-money. Once again, such an exchange depended on the trust that it would be honoured, which in turn would require the existence of sufficient metal reserves by the central banks and that these banks effectively would carry out their obligation to make the exchange in question.⁸ As we know, in the majority of cases this trust did not have an indefinite support, even for the main central banks which managed the last two metallic standards: the Bank of England, during the gold standard; and the Federal Reserve, when the dollar-gold standard was in operation. In these two cases, history as ever, took it upon itself to bury all illusions held with respect to metallic restrictions on monetary policy.

The very advances, transformations and the deepening of the capitalist relations, especially those concerned with the finance and banking system, among countries and economic agents, impelled and demanded that the currency institution, whether in the national contexts or in the international ones, be freed of the necessity of reserves made up of assets with intrinsic and objective values and with a limited supply. The currency made itself autonomous as an institution and started to be managed contingently by a central entity (the central bank).

6 North (1990:36). It is important to notice that contracts can be in both categories, i.e., be formal — for instance, when they are written, with rights and obligations clearly stated as well as informal — when this does not occur. Cf. also Williamson (1979) and Pondé (1993).

7 That is, a convention for the liquidation of debt-credit contracts, including those relative to commercial positions “liquidated” in cash. These conventions are initially established by a central authority, but afterwards they are also adopted by private agents.

8 Hence, we can observe that even when metal money was in circulation, which was based on the value of gold and/or silver (e.g. gold standard; dollar-gold standard) or, mainly, on their representations on paper, copper, or other material, the de facto correspondence between the metal reserves and the M1 were always insufficient, which was one of the reasons why these standards were abandoned.

Concomitantly, the theoretical discussion about "technologies" in monetary policies, over the last decades, has passed, at least in the field of orthodox thought, through various phases: from the discretion and activism of the policy commended in the "hydraulic [and naïve] Keynesianism" (Coddington, 1983), as presupposed in the first version of the Phillips curve, to the rule of a constant growth of money supply defended by Friedman; from the discussion of the independence of the central banks to the defence of the implementation of inflation goals. To a greater or lesser degree, each one of these theories had the objective of finding and defining an optimum monetary policy on the basis of pre-established objectives: control of the general level of prices and of the fluctuation in inflation rates; promotion of a stable growth of the product; control of employment levels; stability of the monetary system; etc.

Nevertheless, it was during the seventies that a strong conviction emerged that the first and most important task of the central banks was to guarantee the consumer prices stability (Browne *et al.*, 1998:4) and, therefore, an optimum monetary policy was that which achieves this objective at the lowest cost. This was the vision which prevailed in the eighties. But recently, Taylor refined the definition of optimum monetary policy⁹ as being that which minimizes a weighed sum of the variance in income with the variance of inflation in comparison to its respective goals (Taylor, 1994). In terms of the minimization of a function of loss (z_t), it would be:

$$r_t = \pi_t + \alpha(Y_t - \hat{Y}) + (1 - \alpha)[E_t(\pi_{t+1}) - \hat{\pi}] + \varepsilon_t \quad (1)$$

Y_t being the level of the current aggregate product, \hat{Y} the desired level *ex-ante*, by the economic authority, of the aggregate product, π_t the current inflation and π the pre-established target for inflation for the period t . The value of the parameter α depends on the preference of the economic authorities, which in turn is related to expected costs caused by the loss of product and by rates of inflation above the expected levels.¹⁰ Still following this rationale, the operational/instrumental variable that the central bank would use to try to minimize these deviations would be the short term interest rate, which, one supposes, is related to stable parameters referred to by the target-variables, \hat{Y} and π . This permits the following definition of the "function of reaction" (rule of Taylor), which leads to the conduct of monetary policy expressed by:

$$r_t = \pi_t + \alpha(Y_t - \hat{Y}) + (1 - \alpha)[E_t(\pi_{t+1}) - \hat{\pi}] + \varepsilon_t \quad (2)$$

9 That is, in what form the operational variables of monetary policy, the monetary base or short term interest rates, should alter in response to changes in the economic variables considered as target variables (Taylor, 1998:2).

10 On the costs of inflation see Driffil *et al* (1990)

in which Y_t , \hat{Y} , π , a were defined as in the equation 1, r_t is the real short term interest rate (operational variable); $E_t(\pi_{t+1})$ is the expectation of inflation for the period following the current management (t) of monetary policy, subject to the information about the economy which the central bank possesses at the time; and ε_t represents other variables which might affect the conduct of short term interest rates. One shall also notice that beyond current inflation, monetary policy should be regulated according to future expectations of deviations in relation to the inflationary target, because of the temporary gap which exist between the change in the interest rate and its effects on the economy.

Supporting this definition of an optimum monetary rule, there is the idea that the monetary policy cannot have only a stable growth of the product as its final objective but must also achieve price stability. A greater emphasis placed on one of these targets implies the acceptance of sacrifices with relation to the other, at least in the short term.¹¹ For as long as the preferences of the economic authority are undefined, the indetermination regarding the optimum rule prevails. Furthermore, any model which tries to delineate the characteristics of this optimum rule undergoes the questioning of the *ex-ante* confidence which it instills in the private agents in terms of the maintenance of the value of the currency in the long term. That is, the monetary policy has to be credible from the beginning to the economic agents, because if it were not, the costs in terms of the production level of a price stabilisation policy would be extremely high. It must be remembered again that those responsible for the monetary policy must conduct it with their eyes directed to the future, i.e., they need to react and counterbalance with anticipation — through changes in the operational variables of monetary policy — the future deviations expected for the product and/or inflation in relation to its targets, given the temporary gap between the execution of the policies and their effects on the economy.

3. Execution of Monetary Policy in an Open Economy

New difficulties are added to the management of monetary policy when it is applied to an open economy scenario. Traditionally, an economist is induced by training to think of monetary policy in terms of a closed economy, because it is in this context that different models related to monetary theory are presented to him/her, including the most famous of them all, the Quantitative Theory of Money. In many of the most favourable cases, the economist is trained to establish a rationale in the fashion of the Mundell-Fleming model, with full mobility of capital combined with the two canonic regimes of financial exchange: in the case of fixed foreign exchange, monetary policy becomes a mere appendix to foreign exchange policies, so it can only be really executed in a regime of flexible foreign exchange. But, in this latter instance, the variations in the

11 However, normally it is defended that the promotion of the price stability by the monetary authorities does not enter into conflict with the objectives of full employment and economic growth in the long run. On the contrary: price stability would be a pre-condition for the achievement of all these goals (Fischer, 1996; Mishkin, 1999).

money supply provoke fluctuations in the foreign exchange rate, which, through their effects on net exportations, the balance of trade, the level of income and the demand for money, affect interest rates, even without having repercussions on the stock of money. In this way, in the Mundell-Fleming model, monetary policy is, above all, the management of the money supply, and not of the interest rate. However, in the real world there is evidence that the central banks run their monetary policy through the management of the interest rates in the short term (Goodhart, 1995; Torres, 1999; Mishkin, 1999).

In addition to this, in an open economy scenario, especially in terms of the flows of international finance, the management of monetary policy becomes much more complex than this traditional model foresees. The effects of monetary policy on the management of private wealth decisions and on the general level of prices are not only felt through the means of interest rates, but also through foreign exchange rates (Ball 1998). That is one reason why, as Hicks stressed (1967:156), monetary theory is less abstract than the majority of economic theories, and its deeper relationship with reality cannot be avoided as it is sometimes in other theories.

Thus, the discussion on monetary policy should always be regulated by its respective institutional apparatus. In this sense, as the execution of monetary policy becomes increasingly complex, in a reality constituted by open economies, it is certainly important to discuss the remodeling of the institutions involved (in which, amongst other things, the operational structure in which monetary policies are chosen is established), including those choices on the very currency through which monetary policies are executed and on the foreign exchange regime related to them.

On the other hand, as Keynes had already recognised in 1923, in *A Tract on Monetary Reform*, the monetary policy making possesses an accentuated expectational dimension, for it has to be managed on the basis of both past and current information capable of subsidising prognoses of future events, whether they are related to inflationary pressures or to the stability of the financial system, in order to try to be positioned against them in advance. Clarida and Gertler (1997), for instance, in their recent analysis of the management of the *Bundesbank*, support this conviction. They discovered evidence that the decision makers of German monetary policy conducted it by trying to anticipate the future, which does not imply that such anticipations are always correct.

Hence, in open economies the relationship between interests and exchange rates deepens, far beyond that foreseen in the Mundell-Fleming model. The interest rate, while directly influencing the prices and the expected yields of the assets in the domestic monetary-financial markets, ends up indirectly affecting financial capital inflows and outflows to and from the several countries (and, therefore, the flows in the capital account of the balance of payments), thus changing the conditions of supply and demand in the foreign exchange market. In a scenario of fluctuating exchange rate, such changes will have repercussions on this rate and, through these repercussions, on the competitiveness of national products in international markets and also on the price level, principally because of the variations in the costs of inputs and of imported products in domestic currency (Vasconcelos & Strachman, 1998). This, for instance, greatly reduces the capacity of the

monetary policy to be conducted efficiently in the fashion of the "inflation target" regime, followed according to "the rule of Taylor" (Svensson, 1998). Yet with a fixed or managed foreign exchange, the effects can be noticed on the foreign exchange reserves of the central bank and on the liquidity level of the economy and, in the case of adoption of a sterilization policy of the inflows of capital, on the domestic public debt. The problem is that, in the real world, the two scenarios often intertwine, as much in their causes as in their effects, that is to say, many countries adopt "dirty" foreign exchange fluctuations, in which they try to maintain certain target zones for their foreign exchange, which may or not be declared (Tobin, 1998).

However the effects of the interest rates on the foreign exchange rate are not known *ex-ante*. The policy makers need to pay attention to the unstable relationship between interest rates and the exchange rate. Such a relationship is permeated by the volatile expectations and the unstable state of confidence (Dequech, 1998; 1999) of the investors with regard to a particular country, in much the same way as with the conditions of the international finance system, including what has already been said in relation to the interest rates of the assets denominated in currencies which carry out the function of international reserve of value.

In a scenario of an open economy deeply inserted in the international financial flows, the central banks do not restrict themselves only to issues such as liquidity positions, expectations and movements of the agents – especially the banks – which take part in the domestic monetary and financial markets. For the domestic currency and the assets denominated in it begin to compete daily with foreign currencies and also foreign assets for positions in the portfolios of the agents, which causes that the central banks have to try to anticipate variations in the demand for its own currency. More than ever the demand for the domestic currency reflects extremely volatile speculative motives of the agents, since they base their decisions not only according to expected variations in the price levels, but also according to the very value of the currency in relation to its foreign counterparts, which is subject to changes caused by modifications in private expectations, frequently not corresponding to any real change in the foreign exchange fundamentals (Vasconcelos, 1998; Williamson, 1999). In other words, the portfolio decisions of the economic agents are affected not only by interest rates, but also fundamentally, at some moments, by the expectations of exchange rate variations. This makes it even more difficult for the monetary policy makers to anticipate the fluctuations in the demand for the currency and, thus, to efficiently manage the system liquidity, through manipulation of the stock of legal tender (currency and deposits in the central bank — Goodhart, 1995:32) and, as a consequence, to manage the basic interest rate of the market, that is, that which determines the price of the bank reserves and "anchors the other interest rates, permitting the transmission of monetary policy (...) to the entire financial system" (Torres, 1999:193).

Therefore, in the same way that there exists a causal relationship between the interest rate and the foreign exchange rate, there is also an inverse relationship, via expectations concerning the future values of the exchange rate. For anticipations of loss of the value of the domestic currency in relation to the most important foreign currencies in

the national exchange market make the agents reduce the share of domestic currency and of assets issued in it in their portfolios. So, the current and expected prices of these assets fall and, as a consequence, their interest rates increase.

Moreover, as indicated above, the basic interest rate expresses the cost of liquidity in the economy, i.e., the cost of the asset which functions as a means of settling contracts, and the central bank has the ability to determine at least the nominal value of this rate. The definition of the real value of this rate, however, depends on the expectations concerning the relative variation of other prices (Goodhart, 1995:34). And these prices are not just those which make up the index responsible for the price level, but also those which establish the price of real estate (land properties, houses) and of financial assets (shares, private securities), which, since the 1980s, have significantly increased their "share (...) in private wealth" (Coutinho & Belluzzo, 1998:137). The point is that in a scenario of an open economy and of growth of the "cross-participation of foreign investors, with the liberalization of the foreign exchange markets and the deregulation of controls on the flows of capital" (Coutinho & Belluzzo, 1998:137), these asset prices are extremely affected by the inflows and outflows of financial capital, which are strongly affected by the exchange rate expectations which predominate between the private agents. This is another way through which exchange rates may influence real interest rates, and hence, the nominal floor for the interests which the central banks have to guarantee if they do not want to be subject to rapid outflows of capital and to depreciations of the assets denominated in their national currencies.

Finally, it is important to underline that the effective operation of a monetary policy is only possible in economies which do not experience long periods of high inflation (Lopes, 1997). Therefore, one must establish which are the necessary conditions or institutional arrangements in order that a national currency may obtain from the private agents a sufficient degree of confidence to satisfactorily carry out its functions.

4. The Pre-Conditions for the Establishment of a Currency

So, what guarantees the confidence and, as a consequence, the capacity of an asset (currency) to carry out the functions of general wealth and of reserve in capitalist societies? As indicated above, the assets which in modern societies fulfill the function of currency, in the majority of cases do not have their values backed by any real asset with its value established by the market. In modern capitalist economies, the currencies are, above all, accepted institutions which are valued collectively in a determined territorial space, thus, being destitute of any intrinsic value. Therefore, would be the confidence in the agents who issue a specific currency (that is to say, at least in this case, the confidence in the governments issuing their respective currencies) a confidence founded on the belief that these agents will not abuse its capacity to issue money, avoiding that the supply of money just reach an equilibrium with the demand via a significant loss of its value? In other words, would there be confidence in that the issuer of the currency will always try to keep it as a scarce asset (Keynes, 1936: Ch. 17), within the economic system? The answer seems to be affirmative.

However, what determines the degree of confidence of the private agents in the monetary policy of these governments? In the final instance, it is precisely determined by

the evaluation of the possibility that the government may systematically issue more money than the private agents will consider acceptable, given the prior decisions and expectational decisions concerning the management of their wealth portfolios. If the agents believe that this possibility is significant, they lose confidence in the capacity of the government to guarantee, through time, the value of the currency which it issues and, in a limit situation (in hyperinflationary stages or in contexts of foreign exchange crises), they might look for another asset which fulfills, even if only partially, the functions of this currency. There is, without a doubt, a measure of uncertainty in this, because it involves evaluations by economic agents as to the future behaviour of the monetary authority. But this uncertainty arises from the very definition of currency as an institution which, even being imposed right from the start by a central authority, is permanently evaluated by private agents.

It is important to keep in mind that the degree of credibility of the monetary policy makers is strictly related to the fiscal stance of the government which issues the currency, for this is the main variable to which the agents attend in order to define the possibility of the government to follow or not an austere monetary policy. There are diverse ways by which the fiscal situation of the government affects the evaluation that the agents make regarding the perspectives of the monetary policy. The most commonly cited in the economics handbooks indicates that if the government is in a constant fiscal deficits situation, it might try to finance them through the issuing of money on a level higher than the demand for real cash balances by the private agents. That implies, once any of the versions of the Quantitative Theory of Money is accepted, that there would be an increase in the price-level.¹²

There is another possible outcome for this connection between fiscal deficit, public debt and interest rates: if there is a succession of fiscal deficits financed by means of the issuing of securities and, as a consequence, if there is an increase in the public debt, the policy maker might have, at some point in time, to adopt a monetary policy of high interest rates. This might implicate, according to private evaluations, in an explosive growth of the public debt, given the current and predicted rates of economic growth and the value of the primary deficits. In this scenario, still according to private evaluations, the government would either have to honour its debt instruments or try to reduce its value in real terms by promoting the acceleration of inflation. In both cases, there would be a deterioration in the expectations of the agents with regard to economic stability, in particular to the price (including of the assets) level. It is necessary to emphasise, however, that the effects of the state of the public finances on the private evaluations concerning the inter-temporal credibility of the monetary policy are not objectively defined, for such evaluations are permeated by volatile private expectations, which either underestimate or overestimate such a state.

12 For a critique of the presuppositions and conclusions of the Quantitative Theory of Money, see Costa (1999).

In conclusion, in order to maintain a stable currency in the course of more dilated periods, it is necessary to attend to a series of conditions: 1) that the public expenditures are adequately financed by fiscal receipts, which implies a desirable absence of public deficits (primary or operational), unless in exceptional circumstances (e.g. economic recession or military conflicts — Keynes, 1936; 1980; Kregel, 1983), or if such a result is not feasible in the medium term, at least in the possibility of adequately financing these deficits through the issue of long term debt instruments. That is, it must be practicable to finance these deficits without having to pay interest rates which could hamper this very financing in the long term, bringing about an explosive growth in debt and in the deficits to be financed.¹³ For this would occasion a distrust in the market with regard to the possibility of the State maintaining and honouring this amount of debt in the future, without using the artifice of reducing this debt via an accelerated growth of inflation or the measures to control it; 2) the monetary policies must be consistent inter-temporally, which implicates in the imposition of certain restrictions on the liquidity to be assigned by central banks and, in this way, in securing the stability of the banking system, minimizing the risk of systemic crises by means of the role of these central banks as lenders of last resort (Keynes, 1936; Davidson, 1980; Mishkin, 1999); and 3) the foreign exchange policies need also to be consistent in the long term, which imply the impossibility of persistence of elevated deficits in current transactions in the long run, moreover if they are not compensated by future increases in the competitiveness of national goods and services, in comparison with those of foreign countries¹⁴ – which might dissipate (or even revert) these deficits in the future. Or, if these deficits are not counterbalanced by sufficient surpluses in the capital account, or still further, by the existence of adequate foreign exchange reserves or by the capability to finance these deficits by means of seigniorage revenues obtained from the issuing of a currency which might be accepted and used as a reserve of value even by foreigners.¹⁵

Therefore, the persistence of elevated deficits in current transactions for long periods, only seems possible without a radical transformation in the goods and services international competitiveness of a country, in the case of the ones which issue hard currencies with a high acceptability in international foreign exchange markets.¹⁶ For these countries are able to obtain revenues from the seigniorage of their currencies, which are widely accepted in the markets, and of selling national assets paying low interest rates (and even property assets) to foreigners, which imply the inflow of financial resources into their capital account, so counterbalancing these deficits in current transactions. It is the existence of both of these possibilities that explains the appreciation of the American dollar (Tobin,

13 As we know, interest rates represent amongst other things the mathematical factor through which a debt grows.

14 Kregel (1983:49n), quoting Keynes (1980:267) with respect to the necessity of Great Britain maintaining a stable balance of trade.

15 For the case of Argentina, a country which after March 1991 has shown huge deficits in current transactions because of the adoption of the currency board and of the economic policies which accompanied it, see Fanelli (1998) and Fanelli & Rozada (1998). The Brazilian case is succinctly described in Vasconcelos & Strachman (1999).

16 Even though these particular currencies are equally subject to depreciation in terms of other hard currencies of the international monetary system, when the deficits in current transactions are not compensated by favourable results in the capital transactions, at least when long term tendencies are taken into account.

1998:3), nowadays the international currency *par excellence*, in various periods, even with the existence of portentous deficits in the US current transactions (above all in the commercial transactions) since the beginning of the 1980s.

Nonetheless, in the case of developing countries, as we have seen, such a persistence of deficits in current transactions, without the compensatory entry of capital and without an improvement in their goods and services international competitiveness, is unviable in the long run. For such countries cannot obtain revenues from the seigniorage of their non-convertible currencies on the international market and because of the existence of stricter limits concerning the attractiveness of their assets for foreign investors, when compared to the developed countries, above all the most important ones.

5. Institutional Requirements to meet the Pre-Conditions of Stability in Developing Countries

On the basis of the analysis carried out in the previous section, it is possible to glimpse in advance some of the barriers which developing countries might face when trying to stabilise the value of their currencies. First, many of these countries perceive themselves as strongly handicapped in their attempts to keep their public accounts in a reasonable equilibrium, or with quite insignificant deficits easy to be financed without trouble for long periods. The difficulty in confronting the financing necessities of the public sector in these countries, which results in great part from their deficient fiscal and enforcing systems, from the impossibility of adequately taxing the privileged strata of society — which hold political power — as well as from the lack of commitment of these groups with the stability of the currency and/or with the development of their countries, make up a whole set of institutions which is very difficult to bypass. And this set of institutions often leads to enduring and completely dysfunctional public deficits, since they neither foster dynamically a more robust economic growth nor work as an instrument for the stabilisation of the fluctuations in the aggregate income (Keynes, 1980; Kregel, 1983).

Second, in the case of monetary policies, the maintenance of adequate levels of liquidity becomes equally difficult. For the liquidity is either excessively high — in the cases where the central banks do not possess the power or the political will to regulate it, ending up by rewarding with liquidity those who hold the power to pressure for it — or too reduced — in instances where interests exist in keeping alive managed exchange regimes which end up by sustaining quite overvalued exchange rate, or in which policy makers recur to excessively rigid price stabilisation policies. Furthermore, it should not be forgotten that a restricted liquidity provide high yields to capital owners, which are welcomed particularly in times in which there are no development projects of great scope being carried out.¹⁷

¹⁷ As we know, it is almost inevitable that serious conflicts will occur between those responsible for the economic and industrial development of the countries and those people and governmental institutions more (or even strictly) concerned with the stability of the currency and of the public finances. There are few instances in which the former win. For the case of France, see Zysman (1978, 1983; 1994) and Hall (1986); for the case of Great Britain, Zysman (1983; 1994) and Hall (1986); for the case of Japan, Zysman (1983; 1994) and Johnson (1982); for the USA, Eisner (1994); and for the case of Brazil, Lessa (1978). A general analysis of these processes can be found in Chesnais (1994).

And third, specifically in relation to the policies for the foreign exchange, the stability of the exchange and the lessening of the impacts of its variations over the prices in a particular country depends on the relative capacity of this country to finance occasional deficits in current transactions via surpluses in capital transactions or, if possible, by obtaining surpluses (or at least "equilibria") in current transactions which are not exceeded by huge net outflows in the capital account. Such a necessity is stronger in the case of developing countries, which, because of their non-convertible currencies with an almost negligible acceptance in the international markets, must pay higher interest rates than in the central countries in order to compensate the exchange risk.

Such conditions, however, might be made even more difficult as a consequence of the recurrent problems of foreign exchange shortage which these countries confront. Thus, in phases of accelerated industrialization, they frequently are hampered by insufficient amounts of foreign exchange when compared to the needs for it to cover some important and/or hardly compressible expenditures (Tavares, 1981). This leads some of these countries, when they are in these phases, to opt for a centralisation of foreign exchange in the hands of the national government and for the establishment of priorities for its use.¹⁸

Another type of problem may be the injudicious use of external debt, which results in later difficulties in fulfilling the obligations of these debts, with possible "cross" repercussions on public debt, when a substantial part of this debt is assumed by the State. In some cases, this indebtedness might be used, at least partially, to balance the shortage in foreign exchange, but in many instances this is not the case. Nevertheless, concomitantly, one can resort to an over-appreciation of the national currency (Fanelli & Rozada, 1998:14-5), so making imports and international trips cheaper in terms of this currency, but (mainly recently) without attaining important repercussions over investments (via cheaper importations of capital goods), especially because of the current refuse to centralise the foreign exchange in the hands of the national governments. For, as is well known, this expediency of over-appreciation of the foreign exchange in order to facilitate capital goods and other input imports has been used favourably by many developing countries, in certain historical moments.¹⁹

18 Cf. Johnson (1982), for the case of Japan, and Lessa (1964), for Brazil in the 1950s. Notice, however, that these subsidies for capital goods imports through an over-appreciated foreign exchange implies outflows of foreign currencies which could often be avoided if the national production of goods were stimulated, so maintaining the buying power within the national borders and stimulating the economy via multipliers and accelerators.

19 For the case of Japan during her phases of rapid industrialization, cf. Johnson (1982). For the Brazilian case in the 1950s, see, among others, Lessa (1964).

Therefore, in many cases, this heavy outflow of foreign exchange from the developing countries occurs as a result of inconsistent, if not irresponsible, economic policies,²⁰ which are chosen by the policy makers and supported by institutions and interests which foster such a choice.²¹ On the other hand, since not even the institutions or ideologies are optima, one can try to understand the "irrational" systemic behaviour of the various individual agents, including that of the policy makers — even if they show a certain rationality when considered individually²² — also as an adaptation to the current institutionality (for they have no manner to modify, at least substantially, the collective behaviour by means of individual decisions). And generally they do not question the systemic repercussions of their decisions, and sometimes do not even perceive the existence of such repercussions.

This path-dependent behaviour is common either with institutions or ideologies. One can also understand this kind of problem as a lack of co-ordination between the decisions of the various economic agents (Chang, 1994). But even in such a case, the State would have the possibility of favourably exerting this role of coordinator. Nevertheless, the opposite occurs in many cases, with the State acting to reinforce the systemic irrationality resulting from the actions of the various individual agents, sanctioning them, even yielding to the pressures of these selfsame agents in order to have guaranteed the profitability of their investments, whether or not productive, be they with clear speculative tendencies or not. Still, in such a case the State is only motivated to resolve, at least partially, certain systemic risks which manifest themselves precisely because of the uncoordinated action of the several agents, which is often corroborated by a deficient institutionality. But, any moral risk arising from such types of aid on the part of the States is better than the costs which arise from the consequences of a general crisis of liquidity and confidence, including the costs for those who, though not responsible for that crisis, might be severally hit by it, as a consequence of having less (or even no) means of protection against their effects (Tobin, 1998:20; Aglietta, 1998).

20 As Fanelli and Rozada (1998:15) emphasise, "the fundamental macroeconomic policies must be consistent with the chosen exchange rate regime. If they are not, sooner or later the regime becomes unsustainable, and in the interim, the economy will pay the costs in terms of risk." See also Fanelli & Rozada (1998:17,34).

21 Amongst them, perhaps the principal is the increasing liberal attitude of various countries in relation to capital flows (Tobin, 1998:7; Mishkin, 1999:9n), including of several ones which had been clearly anti-liberal throughout their history, as was the case with many nations of East Asia. However, many of these nations recently suffered vigorous attacks against their foreign exchange rates, while those nations which maintained an effective control on their capital account, like Taiwan, emerged relatively unscathed from these speculative waves, begun with the first foreign exchange crises in Thailand, in 1997 (Vasconcelos & Strachman, 1997; 1999). This recent liberal attitude is equally the case of Brazil, which had a history of strong restrictions of access to its official reserves until the end of the 1980s, in opposition to countries like Mexico and Argentina, which historically suffered recurrent and violent attacks against their foreign exchange rates. Nevertheless, countries like Chile and Colombia (Tobin, 1998:18; Fanelli, 1998:8; Fanelli & Rozada, 1998:34) have kept themselves relatively safe from such speculative waves, because they had imposed restrictions on the capital flows to and from their countries, which were more imperative when contrasted with the progressive volumes of financial flows on a global scale (Tobin, 1998: 18-20; Eichengreen, 1998:21-2).

22 E.g., in the bandwagon behaviours (Harvey, 1996; Vasconcelos, 1998; Vasconcelos & Strachman, 1999)

All of these affirmations might be illustrated by typical attitudes against the long term stability of the national currencies and/or the development of the countries, as has already been underlined in the examples of squandering of foreign currencies, but also of public receipts and/or expenditures, or even in deficient monetary policies. Hence, the countries might assume foreign debts which are inconsistent with their future capability to pay for the obligations which resulted from these debts; equally, they might cling to overvalued foreign exchange rates or to a deficient protection of their productive sectors, dissipating foreign currencies on quite useless goods and services — in terms of future increases whether of their productive capacity or of their productivity.

It is owing to these various long term inconsistencies in relation to the stability of the national currencies and to institutionalities which are not favourable to stability, and which at the same time are little open to changes,²³ that proposals arise in the developing countries of total or partial renunciation to national currencies as well as to the autonomy of the indigenous monetary policy makers. Therefore, it can be said that the adoption of a foreign currency, whether this adoption is complete or partial (i.e., by means of a currency board), implies the attempt to import a specific institution, a determined foreign currency, but without the necessity of building up the other institutions and preconditions which endow stability to a currency, as well as without adopting the entire institutionality which grants an increased rationality to the economy and society of the country which issues this currency..

Nevertheless, it is also necessary to emphasise that this maturity of developed countries concerning the institutional preconditions for the stability of their currencies (Mishkin, 1999:6,27-8,39) — with monetary, fiscal and exchange policies which are consistent with this objective — is a consequence, to a large extent, to the interests of the financial markets in reduced inflation rates and to the weight of these markets in the determination of economic policies, to the detriment of other goals (Hall, 1986; Chesnais, 1994; Minsky & Whalen, 1996-97: 165-6; Krugman, 1999; Mishkin, 1999:35-6).

6. Proposals for the Renunciation to National Currencies or for the Adoption of Currency Boards

As we have seen, proposals for the renunciation of independent national currencies appear as a possible solution to the problems of economic and monetary stability which arise from certain institutional characteristics found in many developing countries. Such a stance was defended by Milton Friedman, in 1972, during his *Horwitz Lectures*. He affirmed that any developing country with a central bank would be condemned, because a discretionary monetary policy making would lead to a combination of high inflation rates with low rates of economic growth, for reasons connected to their institutionalities (Hanke, 1999). The solution, in Friedman's opinion, would be to eliminate the central bank in these countries, amalgamating their national currency with a strong currency, whether through

23 As is inherent to institutions and institutionalities, in their mixtures with power relations, established interests etc. (North, 1990), all this assuming a set of characteristics having as their foundation a particular path.

an orthodox currency board system (which would issue money backed by a minimum of 100% in a strong foreign currency)²⁴ or through the official adoption of the dollar (Hanke, 1999). But it was only in the 1990s, with the successive foreign exchange crises which hit some developing countries and with the example of European monetary union, that this Friedman's stance gained strength in economic discussions.

Many authors propose that a first solution for the countries issuing "weak" currencies is to settle a fixed foreign exchange rate in relation to a foreign currency which would function as reserves and as an "anchor", a robust base for stabilising this weak national currency. An alternative to this solution is to establish certain moving targets for the exchange rate, in relation to this "anchor-currency" (Mishkin, 1999:2), or even in relation to a basket of currencies, generating a "crawling peg" system. But this last resource will not be analysed in more detail in this paper, because it concedes a much greater autonomy to national currencies, only establishing certain targets (formalized or not) for the foreign exchange rate, in spite of the restrictions which it implies to the monetary policies of the countries which resort to it (Mishkin, 1999: 4-11,30-1).²⁵

Therefore, the first solution to be examined is the maintenance of a determined national currency, although formally and legally pegged to a hard currency, by means of the so-called currency boards.²⁶ As Tobin explains (1998:12), "[a] currency board requires 100 percent reserves in hard currency against the local-currency monetary base." And a second possible expedient is the pure and simple renunciation to a national currency which experience recurrent stability problems.

An initial issue emerges in the cases in which a national currency may be exchanged for reserves through means of cheques. For, as we know, the banking multiplier, M_1 , might exceed by far the original monetary base, which implies the lack of guarantees that the central bank will be able to honour all the demands for exchanges of local currency (especially, those in the form of domestic bank liabilities) for hard currency, although it attempts to follow the established rules for convertibility (Tobin, 1998:12-13). One way of bypassing this issue would be through an increase in the compulsory reserve requirements of the banks. Consequently, there would be a reduction in the banking multiplier and in the M_1 , because the banks would be under greater restrictions to widen

24 And which would not act as a lender of last resort, would not establish the reserves requirements of the commercial banks, would not carry out foreign exchange operations in future markets and would only obtain seigniorage revenues in the form of interests received from portfolio investments of foreign exchange reserves (Hanke, 1999).

25 For instance, because of the need to convey the changes in monetary policies in the country which issues the anchor currency to the countries which are pegged to it. For examples of several European countries which have pegged their national currencies to the Deutsch Mark, and also of other national and anchor currencies, and of the problems and advantages which they obtained, cf. Mishkin (1999:2-12). Nevertheless, it must not be forgotten that an increase in the interests in a country which issues a currency functioning as an international reference, as is the case for the American dollar, can force the other countries to follow their monetary policy, despite of any formal or informal crawling-peg, as it was the case when there was a sharp interest raise in the USA, from 1979 until the mid 1980s.

26 As Eichengreen observes (1998:22), there has been a firm recent increase in the number of member countries of the IMF which adopt currency boards.

their credit operations. Furthermore, there would be an increase in domestic interest rates, which in itself would hinder decisions to borrow, reducing the liquidity and the leverage of the economy in relation to the reserves which back the national currency.²⁷

A second question is the one of huge reserves outflows, which happen as a consequence of national or even international currency exchange crises. In such instances, central banks are obliged to raise the interest rates, in the majority of cases to astronomical levels, in order to avert doubts related to their currency exchange commitment (Tobin, 1998:12).²⁸ But the currency scarcity and the resulting rise of interests, as well as the consequences over the domestic income and level of economic activity, may be so high that the central bank will need to modify its former rules of behaviour, whether through a much higher flexibility of conduct,²⁹ or even abandoning the initially established exchange parity (as it has been discussed for a long time and also currently, again, in the case of Argentina).

It may be noted that a similar effect must occur if the economic activity of the country which adopts the hard currency is to increase beyond the growth to a sufficient extent of its foreign exchange reserves, in order to adjust to and face the instituted convertibility (Tobin, 1998:12). In such an eventuality, in order to avoid attacks on the national currency, it would be necessary to diminish the rhythm of activity by means of an increase in interest rates and/or the adoption of recessive fiscal policies, or still the "simple" restraint of the banking multiplier with, once again, its repercussions on interest rates.

Therefore, since, the solution by means of a currency board is "a way — though a somewhat technically flawed way — of surrendering independent monetary policy and acknowledging vassaldom"(Tobin, 1998:15), why not simply increase the level of this vassaldom and surrender the national currency (though it is not a really independent currency, for the currency boards make the subordinated national currencies completely pegged to a hard currency) and adopt the hard currency itself as the means of circulation and in all other functions, in a country with recurrent problems of economic and monetary instability? For, as a matter of fact, the use of a currency board seems to be a slightly embarrassed way of adopting a foreign currency, without enjoying the eventual benefits

27 Thus, "[a] 100 per cent reserve requirement on bank deposits is a logical extension of the currency board idea... It would allow the system, originally used for British colonies dependent mainly on paper money, to catch up with the rise of bank deposits as the main medium of exchange."(Tobin, 1998:13).

28 As Tobin observes (1998:13-14), "[t]he currency board makes it impossible for the central bank to perform its normal domestic functions, either that of macroeconomic stabilizer or that of lender of last resort.(...) A currency board... sacrifices real macroeconomic performance in all its significant dimensions — production, income, growth, trade, saving, and investment — to the strength of the currency and indirectly to the prevention of inflation. When the successes of the device are touted, it is in these narrow terms. The currency board is an extreme form of the fixed exchange rate as a 'real anchor', a tactic of national self-discipline popular in recent years. However, the true test of successful policy is not conquering inflation by an open-ended sacrifice of prosperity but conquering inflation while achieving full employment and reasonable growth in economic well-being." Cf. also Fanelli & Rozada (1998: 14-6).

29 E.g. augmenting its capability of acting as a lender of last resort, as occurred in Argentina, in the course of the Mexican crisis of 1994. One shall also notice that that country had to receive an important financial help from the USA to maintain the confidence of the market in the established parity between its national currency and the US dollar (Fanelli & Rozada, 1998:2-3).

that this "vassalage" might bring to the country that submits itself to it. Thus, the pure and simple use of a reserve currency might facilitate the monetary policy making, and at the same time diminish the instability resulting of a lack of trust in the existence of sufficient reserves to back the national currency, since this would disappear, making unnecessary any further need of an intermediate currency, and, thus, pressuring for the elimination of the spreads which still exist between the domestic and the hard currency (Hanke, 1999).

However, the majority of the problems arising from the option of a complete use of a foreign currency are the same as those which exist when it is used only partially to back a national non-convertible currency, in the currency board schemes: in these cases there can also occur heavy outflows of reserves as a response to national or international foreign exchange crises, with central banks equally requiring increases in interest rates, in many cases to stratospheric levels, in order to maintain these reserves in a specific country. The currency scarcity and the resulting hike in interest rates might equally reach greater magnitudes, imposing insurmountable obstacles to the growth or even maintenance of the level of activity. These restrictions might be of such an order that some imperfect substitutes for money might emerge (Tobin, 1998:13), above all in their functions as means of payment, but not in the quantity and with sufficient quality to execute with perfection all the functions of money (Keynes, 1936; Davidson, 1972), making possible an avoidance of a severe crisis in the economy. Hence, the reappearance of a national currency might be seen as inevitable, owing to the pressures and the necessity of reassuming a national control over monetary policy (Eichengreen, 1998:26-9).

Certainly similar consequences might happen, as in the case of the currency board, if the level of economic activity of the country which is adopting the foreign currency increases too much, beyond any growth in the capacity of the international reserves to meet the circulation and reserves needs. Once again, in such a case, it would be necessary to reduce the level of activity by means of an increase in the interest rates (e.g., via higher banking reserves needs) and/or by means of the adoption of restrictive fiscal policies.

Another problem, which important economists and representatives of countries that issue hard currencies (Tobin, 1998:15; Aith, 1999) always emphasise, is that these same countries do not take into account the interests of the nations who vicariously adopt their currencies, when they have to decide about their monetary policies. These subordinated nations would likewise abstain from receiving the small amount of seigniorage revenues which even a mechanism like a currency board allows, even if only to a limited extent, given the restrictions on issuing money not sufficiently backed by hard currencies (Fanelli & Rozada, 1998:4-5). At the same time, even though a country may decide to use a currency issued by another, the international payments made in cheques, payment orders, etc., in hard currencies, on the part of the residents in the subordinated country, may be submitted to a discount tax, because of the lack of trust in the solvency of their national banks and corporations in general (Tobin, 1998:15).³⁰

30 Nevertheless, such a lack of confidence can be mitigated with the dissemination of information concerning these corporations and banks, with the growth of transactions made with them, and also with the progressive facilities represented by the means of communication, capable of providing data concerning a specific client or debtor in real time.

The abdication of a national currency can also be an obstacle to the adjustment of the relative prices of goods in different countries, which might be made with some facility by means of appreciations/depreciations of the currencies (Tobin, 1998:3-6; Krugman, 1999:6; Mishkin, 1999:5-6). However, various obstacles might be imposed in the way of this potential flexibility of the exchange parities, as for instance the determination of certain exchange rate or parameters or even bands or adjustable parities, resulting in the loss of credibility of an economic policy which did not make great efforts to sustain such parity, which is fixed in advance in many cases, as we have seen, and sometimes in an equivocal manner.³¹ These expedients of economic policy are responsible for an excessive erosion of foreign exchange reserves, and excessive increases of interest rates, with their repercussions on public finances and on the level of economic activity. These measures are taken in order to try to maintain the parities at the pre-fixed levels, which, generally speaking, is not achieved, because of the impacts of these high interest rates on the expectations concerning the future parity of a currency.³²

There exists also proposals for some developing countries to give up their respective national currencies in favour of international (in this case regional) ones, issued by a group of them, e.g., those which are more strongly interconnected in an area of commerce and/or through special economic or political agreements. Amongst these interests are those behind the growing international trade of those countries participating in a determined area of commerce, which would receive incentives to grow in the case of a single currency shared by the participating countries; and to avert the political opposition of agents badly hit by sudden increases in importations resulting from rapid over-appreciation of their national currencies (Eichengreen, 1998:4-10,19-23).³³ However, amongst the risks of a single regional currency, there is the necessity of making the

31 "Indeed, a discreet change in an official parity is much more traumatic. It is a loss of face and a blow to pride. It is an administrative decision, that is to say a decision of policy and politics. It necessarily requires responsible officials – finance ministers, chancellors, central bank chairmen – to go back on their solemn word. Moreover, they or their successors have the unenviable task of choosing a new rate in a climate poisoned by distrust, clouded by uncertainties about the fundamentals, and dominated by unpredictable psychology. It's easy to get the choice wrong, prolonging and aggravating the crisis. For all of these reasons, there is a great temptation to stick with an overvalued parity too long." (Tobin, 1998:8).

32 Tobin (1998: 8-12), Mishkin (1999: 5-6) But even the results of such a firmness in the defence of an pre-established exchange rate might be extremely expensive for a country. For instance, in the speculative attack against various European currencies, in September 1992, only France was disposed to defend the franc until the very end, while other currencies were devalued in relation to the mark. France took up higher costs to maintain this parity, in the form of much lesser growth rates, after 1992, than the other European countries which permitted their currencies to depreciate. The collective costs in terms of hard currencies reserves for the governments of Great Britain, France, Italy, Spain and Switzerland were around US\$ 100 billion, to be added to the US\$ 50 billion spent by the Bundesbank in the attempt to aid various European partners in the defence of their parities, with estimates of loss of between US\$4 billion and US\$ 6 billion in this intervention process, to be paid by the group of Treasuries (Mishkin 1999:5-6). In another example, there are estimates that if the interest rates in Brazil, in 1998, had been reduced to levels equivalent to those in Argentina, the Brazilian public deficit would have fallen from 7% to 3.2% of GDP (Eichengreen, 1998:26n).

33 Such a proposal arose between countries of the Mercosur, also as a result of a series of interests and unresolved questions. Amongst these questions was the over-appreciation of the Argentinean peso, which could be resolved by a regional currency, releasing that country from the trap imposed by the currency board without submitting to a depreciation of its national currency. One shall notice that when this proposal was initially made, a regional currency was seen equally as a way out for an over-appreciated Brazilian real, i.e., as a simultaneous solution to the over-appreciation of the two principal currencies of that agreement (Eichengreen, 1998:4, 25-6).

different interests of the various countries converge on common economic and monetary policies, in order to constitute an "optimum economic area" (Frankel & Rose, 1996).³⁴ This might be difficult, e.g., because of the differences concerning exports levels (and the goods and services which make up exports) and also in consequence of the different levels of industrialization of these countries, which require diverse reactions in terms of exchange rates to face variations in internal and external prices, in the prices of the commodities and of more sophisticated industrial products, and in the competition capability of the several sectors, etc. (Eichengreen, 1998:7-11,33). The point is that the very process of economic convergence between the countries proposing the adoption of a single currency might be only achieved after it is implanted, that is, the degree of necessary integration for the formation of an optimum monetary area might be only reached *ex-post*. In this way, there is the possibility that the first years of the implantation of a monetary bloc might become extremely costly in terms of losses of output and employment caused by external shocks (Frankel & Rose, 1996).

Nevertheless, it is equally necessary to mention the benefits of resorting to a foreign currency as a national currency, whether in its "pure" form or in the form of a currency board. Amongst these benefits there is the reduction of uncertainty in terms of the level of the future exchange rate (complete in the case of the extinction of the domestic currency) and also of the monetary and fiscal measures which could be necessary to counterbalance modifications in this rate and in the inflation rates (Fanelli & Rozada 1998: esp. 16-17). At the same time, the reduction in inflation rates which might follow such an option diminishes the dispersion between the various prices in the economy. In the specific case of the currency boards, this occurs particularly when this regime of exchange functions as a nominal anchor, mainly through an over-appreciation of the exchange rate, which generates a tendency to lower the price of imports in terms of the national currency. This lower prices stability, together with the fixed exchange rate, may increase the revenues of *seigniorage* obtained from stabilisation, especially if this makes the country more attractive to capital inflows.³⁵

7. Final Remarks

The paper tried to present some relevant, but sometimes unconsidered, aspects for the discussions about monetary policy. The existence of new conditions restricting monetary policies in a world economy with generalised exchange liberalization and deregulation of capital flows is indisputable. Such restricting conditions are stronger in developing countries, because their currencies are at a permanent risk of not being accepted as liquid assets by the managers of multiple currency portfolios. To these new

34 An optimum monetary area might be defined as a region which is neither so small or open that it would be better to peg its currency to that of a neighbour, and nor so big that it would be better off separating itself into sub-regions with different currencies (Frankel & Rose, 1996:14).

35 E.g., in Argentina, there was a fivefold increase in the currency utilisation, after the Convertibility Plan, in March 1991 (Fanelli & Rozada, 1998:34-6).

contingencies one should add the pre-existing structural problems, which make it even more difficult for the monetary policy makers to execute over time a policy which is both coherent and compatible with some other objectives (income and employment growth, etc.), beyond that of defending the national currency against waves of lack of confidence in the international markets. In such a scenario, even the objective of making the monetary policy coherent through the establishment of inflationary targets shows itself, *a priori*, flawed, as a consequence of the unstable relations between interest rates, foreign exchange rates and prices.

However, given the recurrence of exchange crises in developing countries in the last years, there is a resurgence of the voices proposing the renunciation, whether partial or complete, of their national currencies, and each time these voices are stronger. Less informed people believe that through such a device, these countries will be forced to introduce the same institutions which guarantee economic stability (and prosperity) in the central countries. Perhaps a more viable solution has been given by a group of economies which are, when compared with those of the main developed or (even) developing countries, relatively small. Given the impossibility, at least for now, to impose any effective control on the free movement of capitals between the main developed countries (which are the sources of this capital as well as the beneficiaries of its profits, which explains the pressure for the maintenance of and even for an increase in this liberty of movement), the developing countries — given their much more limited opportunities of reasonably participating with impunity in such flows — must try to find a way to manage more carefully their interventions in these capital flows, without waiting for measures which necessitate the collaboration of the developed countries, given their aforementioned lack of interest. This is what Chile, Colombia and Taiwan have done. These countries, even benefiting only a little less from the initial inflows, could control the outflows in a more effective manner when the direction of the flows inverted, maintaining a much higher level of freedom concerning their economic policies — and achieving a much higher level of stability for their currencies — since they possessed (and still do) a greater control over their foreign exchange operations.

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