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KICKING THE HABIT: MOVING FROM PEGGED RATES TO GREATER EXCHANGE RATE FLEXIBILITY

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Why do governments find it so difficult to move from pegged exchange rates to greater exchange rate flexibility? I first establish that there is a problem to be solved: that there are powerful incentives for greater flexibility deriving from changes in the international economic and financial environment but that policymakers find it difficult to engineer a smooth transition. I offer practical suggestions and a framework under which the probability of a smooth transition can be maximised. Drawing examples from recent economic history, I then attempt to understand the experience of selected countries which have undertaken this transition.

In a period when events in Asia challenge the powers of comprehension of the most mentally agile observer, it is natural to seek guidance – not to mention solace – in the wisdom of Confucius. Not surprisingly, Confucius noted the problem I intend to discuss today. 'It is not really so difficult to leave', he wrote. 'The question is why so many refuse to use the door'.

The question I take up in this lecture is why governments find it so difficult to move from pegged exchange rates to greater exchange rate flexibility – what is known in the policy community as the 'exit' problem. The evidence indicates beyond a shadow a doubt that there is a tendency toward greater currency flexibility. Fig. 1 displays data for developing countries over the last 20 years. It distinguishes countries which report their exchange-rate regime to the IMF as a managed or independent float, on the one hand, and those which peg to a single currency, the SDR or a basket, on the other. The top panel shows the number of countries reporting these two types of arrangements, the bottom panel the share of developing country output (measured as real GDP at purchasing power parity) accounted for by each. The trend is beyond dispute. There is no question that we are observing a move toward greater flexibility.[1]

This is something that Europeanists tend to forget, given the publicity

[*] Delivered as the Harry Johnson Lecture to the Annual Conference of the Royal Economic Society, April 1998. The author is John L. Simpson Professor of Economics and Political Science at the University of California, Berkeley. This lecture was written while he was on leave as Senior Policy Advisor at the International Monetary Fund. The normal disclaimer, that the opinions expressed here are not those of the IMF, applies with special force. This lecture builds on closely related work with my IMF colleague Paul Masson and draws on Eichengreen and Masson (1998). In thinking about these issues, I have been heavily influenced by Michael Mussa. While the aforementioned individuals share the credit for any insight this lecture contains, it should not be inferred that they necessarily concur in its conclusions.

[1] That said, anyone who has worked with the data in the IMF's *Exchange and Trade Restrictions* annual knows that these must be treated wiht caution. In particular, a number of countries which report their regime as one of limited or managed flexibility attempt in practice to hold their exchange rates within a relatively narrow range or to peg it informally. But while the precise numbers displayed in the figure are subject to a margin of error, the overall trend is beyond dispute.

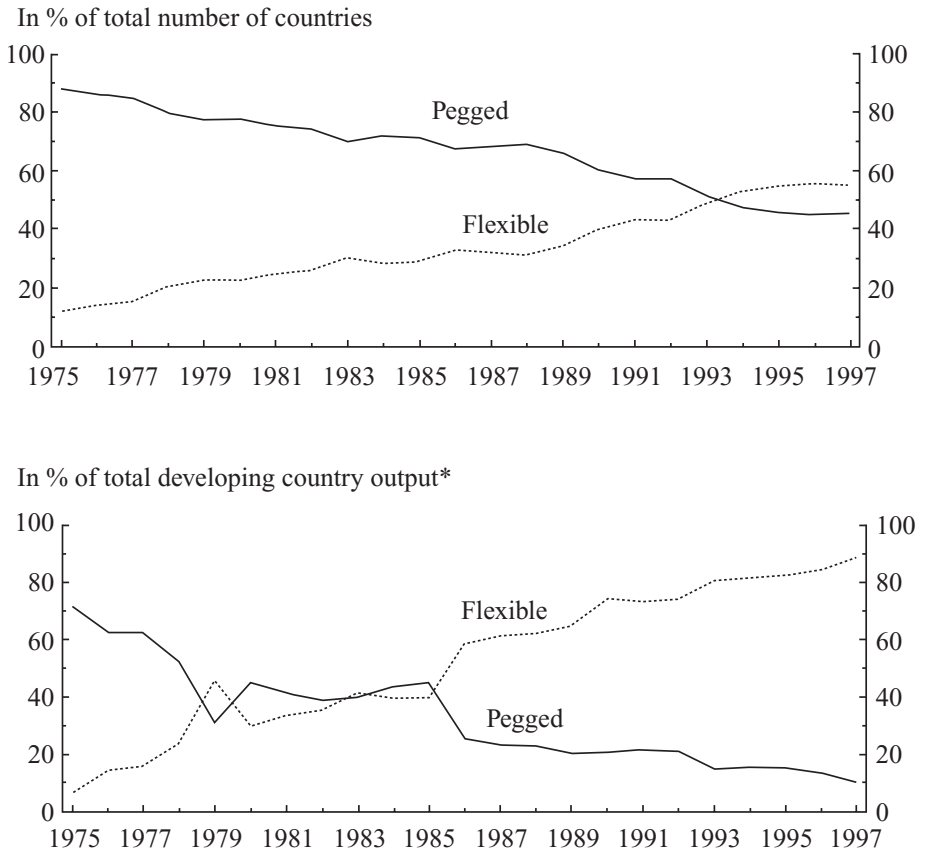


Fig. 1. *Evolution of Exchange Rate Regimes in Developing Countries*

Notes: 1997 figures are the author's estimates up to Oct 31.

The classification is based on officially reported exchange rate arrangements as of year-end. 'Pegged' regimes include exchange rate arrangements in which the currency is pegged to a single currency, to the SDR or to a basket of currencies. 'Flexible' regimes consist of exchange rate arrangements in which the exchange rate follows a managed float or is independently floating. For some countries, the exchange rate may be classified as 'managed floating' or 'independently floating' but in fact is informally pegged. The differences between pegged and flexible regimes may therefore not be as significant as those indicated in the figures. The total number of countries included increases over time in keeping with increasing Fund membership.

* Real GDP, valued at purchasing power parties, of developing countries in each regime as a share of total developing country GDP.

Source: *World Economic Outlook*, Oct 1997.

surrounding the European Union's effort to stabilise intra-European exchange rates. But it is hardly farfetched to argue that the drive for monetary union is itself a response to these same pressures for greater exchange rate flexibility. Intra-EU currency swings have political repercussions: by bestowing a capricious competitive advantage on some producers and provoking protectionist

lobbying by others, they undermine support for the Single Market Project. As a result, European leaders have concluded that they have no choice but to eliminate this problem by abolishing intra-European exchange rates once and for all.

What are these pressures for greater exchange rate flexibility? The removal of tariff and nontariff barriers, for one, has multilateralised the pattern of international trade. As the recent experience of the Asian economies has underscored, pegging to a particular currency is dicey for countries that trade and borrow from a variety of different partners. Pegging to a basket can attenuate but not eliminate the problem: with fluctuations between dollar, the yen, and now the euro unlikely to diminish soon, and with the co-movement of these rates varying over time, pegging to a fixed basket is also likely to be problematic.

At the same time, the vastly expanded volume of international capital flows has made the maintenance of exchange rate pegs infinitely more difficult. The increased mobility of capital has heightened countries' susceptibility to financial disturbances such as changes in the level of world interest rates. And it has enhanced the value of currency flexibility as a buffer against shocks. Countries that are small relative to global financial markets find it extremely difficult to hold their currency steady in the face of massive capital inflows and outflows. Experience has repeatedly shown the very grave difficulty of maintaining an adjustable peg or tightly managed float with occasional large adjustments in the face of internationally mobile capital. Market participants will be aware of the possibility that a country operating such a system might wish to change the exchange rate by a discrete amount if pressures become intense, giving them an obvious incentive to anticipate events and force the issue, potentially in a destabilising way.

Thus, countries that wish to retain a modicum of exchange rate flexibility will have to move toward an arrangement in which the currency is allowed to fluctuate more regularly and over a wider interval. I am not arguing that all countries must float; the economist is no more convincing than the shoe salesman when he insists that one size fits all. Hong Kong has good reasons, both political and economic, to foreswear its monetary autonomy and commit to a currency board. France and Germany have compelling reasons, political as well as economic, to go for monetary union. But countries that are not prepared to delegate national monetary autonomy to a foreign central bank, as with a currency board, or to create a transnational entity like the European Central Bank will face strong pressures to move to a regime of greater exchange-rate flexibility.[2]

Neither is my purpose to revisit the literature on the choice of exchange rate regime (on this, see Wickham, 1985). I am not going to devote much attention to whether policymakers in a particular country are better advised to fix or float. Rather, I focus on the subset of countries that have traditionally limited the flexibility of their exchange rates and now desire greater exchange-rate

[2] This is a conclusion whose realism I have defended at length in Eichengreen (1994).

flexibility. For this subset I ask how they can best complete the transition. How, in other words, can countries that have traditionally operated a peg or a tightly managed float get from here to there?

1. The Exit Problem

The first step is to convince you that there is a problem to be solved. This should not be difficult. Historically, exits – that is, transitions from pegged to adjustable exchange rates – have been anything but smooth. This suggests that there is indeed a need to identify a better way.

Together with Esteban Jadresic and other colleagues at the IMF, I have looked at the historical experience with exits. This involved compiling a comprehensive list of exits by developing countries over the last 20 years, where an exit is defined as a movement from a single-currency or basket peg to a more flexible exchange rate.[3] This resulted in a sample of 29 instances in which countries moved from single-currency or basket pegs to managed or independent floats.[4] We then compared countries exiting from a peg with two control groups: countries which continued to peg without exiting; and all developing countries, whether pegged or floating, aside from our exit cases.

I want to be clear that this is not an attempt to identify the effects of exits. Countries exiting from currency pegs have typically differed from other countries in important respects other than their decision to change the exchange rate regime. Comparisons of countries exiting from currency pegs with other countries reflect more than the effects of the exit narrowly defined. The goal here is more limited. It is simply to document the historical record of exits in order to motivate the need to identify better ways of accomplishing them.

Fig. 2 suggests that exits are typically preceded by gradual nominal and real appreciation and followed by a step depreciation (and, in the case of the nominal exchange rate, by further depreciation over time). Thus, although the definition of exits includes cases of both appreciation and depreciation, the latter have dominated in practice. Real and nominal exchange rate volatility jumps up around the time of the exit. Both remain higher for several months following the event.

Fig. 3 confirms that exits have not been happy events. Typically, growth has slowed in the period leading up to the exit. In the year the exit takes place, growth is negative and significantly below that in both the nonexit cases and in

[3] To be catagorised as an exit, the pegged-rate regime and the subsequent period of greater flexibility each had at last at least two years. All data used to construct the exit cases were nonoverlapping. We also eliminated a few cases of hyperinflation and civil war where the behaviour of macro variables was so extreme as to dominate the comparisons.

[4] Since crawling pegs and crawling bands were already included in the greater flexibility category, cases where countries operating such systems widened their bands or increased their rates of crawl were not included in the sample of exits. While we relied mainly on the offical categorisation of exchange-rate arrangements published by the Fund in its *Exchange and Trade Restrctions* annual and in *International Financial Statistics*, we checked entries for economic content by comparing changes in reported arrangements with changes in actual exchange rates.

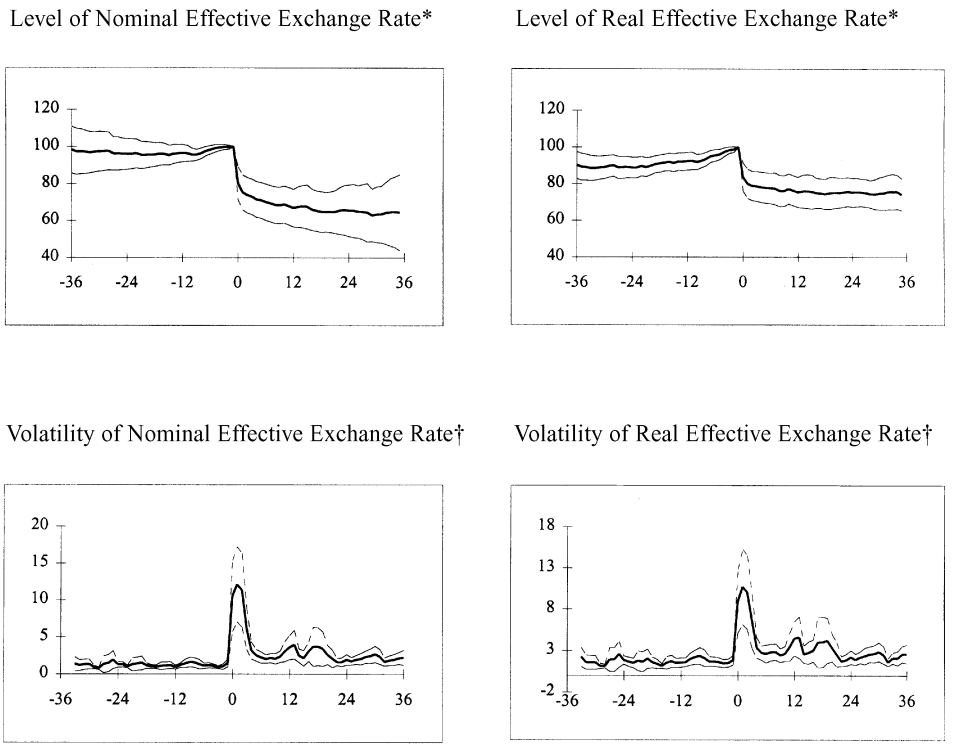


Fig. 2. *Exchange Rate Indicators*
* The base of the index if 100 for the month prior to exit
† Volatility is measured as the standard deviation of the monthly growth rate of the exchange rate over the last three months, averaged across exit cases.

countries with lasting pegs. Export growth also slows, falling significantly below that in both comparison groups in the year preceding the exit. Subsequent to the exit, output and exports recover. As might be expected, exports respond first to the change in the exchange rate; output only begins to revive in the second post-exit year.

Fig. 4 shows the incidence of capital account restrictions in our various groups of countries. It reveals that countries which exit from pegged rates have a significantly lower probability of having maintained capital account restrictions in the period leading up to the event. One interpretation is that governments that have liberalised the capital account also opt for more flexible rates in order to manage their exposure to international capital flows better. Another is that countries with open capital accounts are more susceptible to being forced off their currency pegs. This pattern clearly deserves further study.

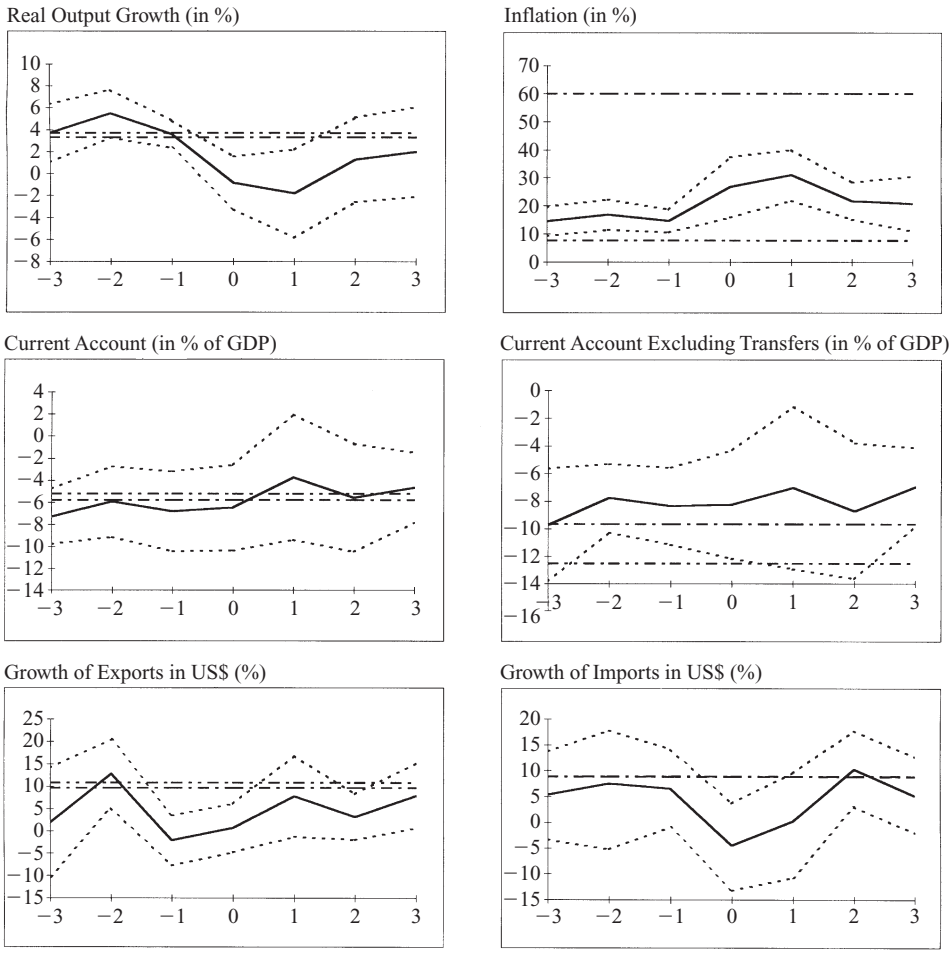
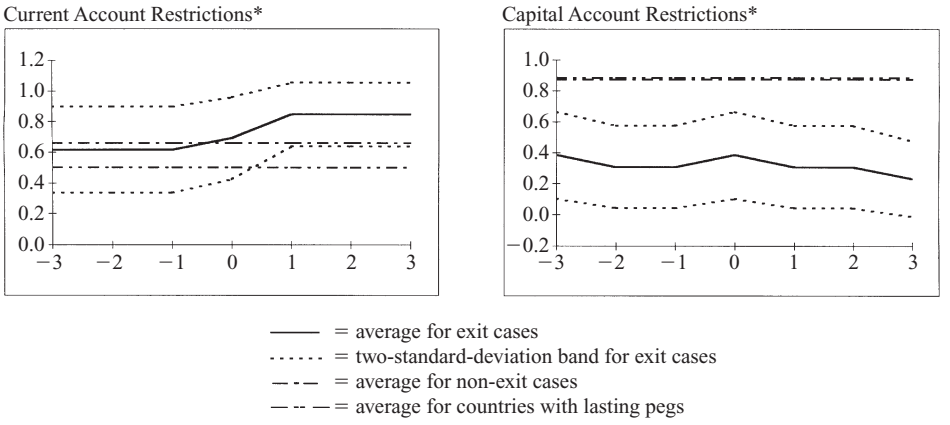


Fig. 3. *Macroeconomic Indicators*

On balance, then, exits from pegged exchange rates have not occurred under favourable circumstances. They have not had happy results. Countries have generally waited to exit until reserves are falling. Exits have been associated with disappointing economic growth, both before and immediately after they take place. There is a clear sense that policymakers are reluctant to face the facts: they fear that exiting from a pegged rate regime will undermine confidence, destabilise the financial system, and depress the economy, with adverse political repercussions. One is reminded of Richard Cooper's 1971 article, 'Currency Devaluation in Developing Countries', in which he observed that the majority of finance ministers presiding over devaluations lost their jobs, and sometimes their heads, within a matter of months, rendering them



*The restriction index for a given country takes the value of one if there are parment restrictions and zero if there are no payment restrictions (as reported in 'The Exchange Arrangements and Exchange Restrictions Annual Reports', IMF)

Fig. 4. *Exchange and Trade Restriction Indicators*

understandably hesitant to devalue. There is a clear sense that officials' consequent reluctance heightens the fragility of the financial system, leading to an unnecessarily high incidence of crises, since the necessary move to greater flexibility only occurs when the markets force it upon the authorities.[5] Clearly, there is a need for a better way.

2. Moving in a Period of Capital Inflows

The fact that most exits have taken place in periods of speculative pressure and are associated with adverse economic outcomes and a loss of credibility by the authorities underscores that exiting in a crisis is problematic. Policymakers have an incentive to cling to the peg in the hope that the storm will pass and to put off the day of reckoning. Insofar as they reaffirm their commitment to the peg, the consequences of then being forced to renounce it are even more devastating.

This suggests that countries should take advantage of periods when capital is not flowing out to introduce greater exchange rate flexibility. Ideally, this would occur when there are no sharp pressures for either appreciation or depreciation. Before you conclude that this paper was written by Dr. Pangloss, I should acknowledge that such happy periods are few and far between. Capital flows to developing countries occur in waves, alternatively surging in and surging out. One way to understand this is in terms of the response of foreign investment by advanced industrial countries to the level of world interest rates. History points to a series of episodes in which capital has surged into emerging markets in a manic scramble for yield, interspersed with periods of higher

[5] 23 of the 29 exits in the sample coincided by crises as defined by the Frankel-Rose (1996) criterion.

global interest rates when there is little net lending to developing countries or there are even net transfers in the other direction.

Thus, policymakers face the difficult choice of whether to introduce greater flexibility when capital is flowing in and the exchange rate is under pressure to appreciate or hoping that a transition that takes place when there is downward pressure on the currency can somehow be managed adequately. To be sure, it is difficult to introduce greater flexibility during the period of inflows. The currency's upward movement will not be happily received by exporters. But the countervailing arguments for ignoring their complaints and moving at this time are compelling. These are three.

First, appreciation during the period of inflows can damp down the excess demand and speculative bubbles that characteristically arise at such junctures. Second, making clear that what can go up can come down introduces an element of exchange risk that can itself moderate capital flows. Third, a higher level of exchange rate variability will encourage banks and corporates to hedge their foreign currency exposure, protecting them against capital losses and bankruptcy risk if and when the currency moves down. Recent events have made the benefits of this last effect abundantly clear. In Thailand, for example, the government's reluctance to introduce greater exchange rate flexibility during the period of inflows and its insistence on maintaining its currency peg encouraged banks and corporates to accumulate unhedged foreign currency exposures which left them vulnerable when the exchange rate suddenly changed.

Let me cite some examples of countries that have succeeded in pursuing this strategy of introducing greater exchange rate flexibility when capital is flowing in. Take, for example, Poland. Poland used an exchange-based stabilisation scheme to bring down inflation starting in 1991.[6] The currency was pegged to the dollar and then to a basket starting in May of that year. This coincided with a period of historically low interest rates in the United States and Japan and a period of capital flows to emerging and transition economies. Capital inflows into Poland rose steadily in every year from 1991 to 1995. Yet despite the fact that most restrictions on capital-account transactions were quickly abolished, exchange rate flexibility was gradually and progressively increased. In October 1991 the basket peg was replaced by a preannounced crawling peg. Following a trio of step devaluations, the authorities shifted in May 1995 from a crawling peg to a crawling band in which the currency was permitted to fluctuate by plus-or-minus 7%. And early in 1998, Poland's newly-established Monetary Policy Council used its first press conference to widen that band from 7 to 10% as a way of introducing more of a two-way bet into the foreign exchange market.

Or take Israel in the 1980s. There too, in this case in 1985, the currency was pegged to the dollar as part of a programme of exchange-rate-based stabilisation. Following a pair of step devaluations, the country introduced a plus-or-minus 3% fluctuation band in March of 1990. In December 1991, the fixed

[6] For details, see Sachs (1994).

band was replaced by a crawling band whose width was widened to plus-or-minus 5%. In May 1995 the fluctuation band was widened to plus-or-minus 7%. These modifications took place against a backdrop of substantial capital inflows (in every year but 1992) and progressive capital account liberalisation.

Or take the case of Chile. It's experience extends over a longer period than these others, but it points to the same conclusion. Chile pegged its currency as part of an exchange-rate-based stabilisation scheme in the early 1980s. After various twists and turns, it moved to a crawling peg in September 1982 and a crawling band in 1985. The band width was widened to plus-or-minus 3% in 1988, plus-or-minus 5% in 1989, plus-or-minus 10% in 1992, and plus-or-minus $12\frac{1}{2}$% in 1997. In every year from 1985 to 1996, the country experienced capital inflows, generally in excess of 4% of GDP. Again, Chile's experience shows that it is possible to exit in a period of persistent inflows.

Finally, consider the case of Singapore, which floated its dollar in 1973. Its case is particularly interesting because Singapore was operating a currency board, and countries tend to be particularly reluctant to abandon a currency board for greater exchange-rate flexibility for fear that the shock to confidence will be destabilising. This was not the case when Singapore floated its currency on June 21st, 1973. Until that time, Singapore effectively pegged to the U.S. dollar; U.S. inflation therefore meant imported inflation. When the Ministry of Finance unexpectedly announced that the currency would be allowed to float, there was no shock to confidence. The critical point is that the decision to float was taken against the backdrop of a heavy influx of capital, reflecting monetary instability in the United States and industrial unrest in France and Italy. The Singapore dollar appreciated against the U.S. dollar by about 7% between June and July and then fell back to pre-flotation levels by the end of the year, after which it remained relatively stable, epitomising the successful exit. Not only can it be done, in other words, but even currency board countries can do it.

3. Nuts and Bolts

Having established feasibility, can we provide a set of specific instructions for countries seeking to move smoothly to greater exchange rate flexibility?

A first recommendation is to establish an alternative nominal anchor once the pegged exchange rate is no longer the reference point for monetary policy. This may mean adopting an inflation or money growth target. But given the difficulty of implementing formal inflation and money supply targets in developing countries, it may simply mean making clear that low inflation is a key objective of monetary policy. It may mean giving the monetary authorities a mandate to pursue that objective and conferring greater operational independence on the central bank. We can debate why the UK and Swedish shifts to greater flexibility in 1992 worked more smoothly than the Mexican devaluation of 1994–5 and the Asian devaluations of 1997—I can think of several reasons—but one factor surely is the adoption by the Bank of England and the Riksbank of explicit and transparent inflation-targeting rules.

Second, maintaining confidence once the exchange rate has been removed as the anchor for monetary policy and there has been a fundamental change in regime may require strengthening fiscal policies and institutions. Recent research suggests that more centralised budgetary institutions and procedures which vest responsibility for fiscal policy with the prime minister or the finance minister, give less discretion to spending ministries, and require the parliament or congress to vote on the overall size of the budget are associated with smaller deficits and debts.[7] Reforms that move in this direction should give markets greater confidence that fiscal policy will deliver smaller deficits and put less pressure on the central bank for inflationary finance.

I see this as a corollary of the theory of the second best. In countries where the exchange rate was pegged as a second-best expedient to offset inflationary biases in the formulation of monetary and fiscal policies, a smooth transition to greater flexibility requires first eliminating the domestic distortions that prompted the adoption of the currency-pegging policy in the first place. It does not mean that it is unwise to move to greater exchange rate flexibility until all domestic distortions have been removed and all domestic credibility problems have been solved, only that countries which adopt their pegs for credibility-related reasons will enjoy a smoother transition if they concentrate on removing the sources of inadequate domestic credibility that induced them to limit exchange rate flexibility in the first place.

Third, it is desirable, where possible, to move gradually. Banks and firms will have to adapt themselves to the new environment. An extended period of currency stability will have encouraged them to acquire large unhedged foreign currency exposures. Banks with foreign-currency-denominated liabilities and domestic-currency-denominated assets will find themselves in trouble when the exchange rate suddenly begins to depreciate, especially if it depreciates sharply. Firms with foreign-currency debts but domestic-currency revenues can be thrown into bankruptcy by a sudden depreciation. If greater flexibility is introduced gradually, they will have time to learn to hedge, and the new regime will operate more smoothly.

Of course, phased adjustment to a new exchange rate regime is easier said than done. Readers will be aware of the difficulty of attempting to depreciate the rate gradually when speculators know what is coming. That said, it is easier to move gradually when the predominant pressure is for appreciation. The authorities will have been intervening and accumulating reserves to prevent the rate from appreciating; they can simply intervene less. If they make clear that the brave new world is one of two-way bets – that what can now go up can also come down – phasing in greater flexibility may not be impossible. Again, Poland is an example of a country that succeeded in doing so despite an almost entirely open capital account.

Fourth, it will be desirable to continue managing the exchange rate, at least to an extent. Exiting from a peg to a regime of greater flexibility does not necessarily mean exiting to a free float. A freely floating currency is less desirable for a

[7] See for example Alesina and Perotti (1994).

developing country subject to large external shocks and with thin financial markets than for, say, the United States or the European Union. In addition, there is the fact that where data on monetary and fiscal variables become available only with a lag, observers may make inferences about the stance of policy from the behaviour of the exchange rate itself. It may be desirable under these circumstances to prevent the newly-unpegged rate from depreciating excessively, since a sudden decline may lead incompletely-informed observers to infer that policy is loose and that the authorities are not committed to maintaining the currency's value. This seems to have occurred in Mexico in early 1995 when the peso's fluctuation bands were abandoned.

For all these reasons, abandoning a regime of narrow bands or pegged but adjustable rates, in which the anchor for policy is an explicit and rigid exchange-rate target, for a freer float does not mean forsaking all intervention. Recent experience in Asia underscores the point: it illustrates how very volatile floating exchange rates can be and how extrapolative expectations can give rise to an unstable situation.

Post-exit intervention in the foreign exchange market requires international reserves, of course. This is another argument for not waiting too long—for exiting before reserves have been exhausted in a futile defence and the subsequent capacity to intervene has been destroyed.

Fifth, it will be desirable to strengthen the condition of the banking system before exiting if this can be done without waiting too long. If bank balance sheets are weak and financial institutions have large open foreign positions, they may be unable to manage the increase in exchange rate variability. Depreciation of the currency can then provoke bank insolvencies, undermine confidence in the economy, and lead to further currency depreciation and further bank insolvencies. This creates an obvious argument for strengthening the position of the banks – for cleaning out nonperforming loans, raising capital and liquidity requirements, and tightening restrictions on open positions – before exiting the peg.

To be sure, this same logic can provide an excuse for doing nothing. The same economic problems that motivate the desire to adjust the exchange rate also provide an excuse to delay. It is the plea of the sinner, 'Save me O Lord, just not yet'. In Thailand, for example, the authorities were repeatedly warned of the problems with their currency peg and of the need for greater exchange-rate flexibility. Their response was 'You have a point, but we must first finish strengthening the financial system'. Readers will be aware of the result.

In theory, there should be an interior solution to this problem, as for any well-behaved economic optimisation problem. The marginal benefits of additional bank restructuring presumably decline over time. The marginal costs of delaying the exit presumably rise. The optimal time to exit is when the marginal benefits of waiting are about to exceed the costs. This time, while positive, is presumably finite, as for any well-behaved economic problem. But the situation is more complicated when these two relationships are neither independent nor well-behaved. Say that the longer the authorities wait to relax the currency peg, the less their incentive to sink the costs of cleaning up the banking system. Or say that the longer the authorities defend the exchange

rate with a policy of high interest rates, the weaker the banking system becomes, and the more costly and time consuming it becomes to clean it up. Delay can then be a recipe for disaster.

4. The Asian Crisis in this Light

The recent currency and financial crisis in Asia illustrates many of my points. A number of us had been arguing for some time the need for greater exchange rate flexibility in the region. I could cite a paper Tam Bayoumi and I wrote for a conference in Seoul sponsored by the Korean Development Institute and the Association for the Monetary Union of Europe in December 1996 (Eichengreen and Bayoumi, 1996), in which, for example, we criticised the notion that the countries of the region might operate a common basket peg and argued instead for greater exchange rate flexibility.

Thailand provides perhaps the clearest case in point. The IMF had been arguing the case for a more flexible baht for more than a year prior to the Thai crisis. But the Thai authorities, like the Mexican authorities two years before, were reluctant to devalue in the run-up to a presidential election, fearing loss of face and negative reputational consequences. They feared that a significant devaluation would damage the balance sheets of already weak financial institutions and preferred to wait until the problems in the financial system had been sorted out. But the high interest rates needed to continue attracting capital and then to keep it from flowing out only heightened the banking system's dependence on short-term foreign funds. They depressed the stock market, further weakening the balance-sheet positions of the banks, the finance companies, and their corporate customers. The authorities failed to capitalise on the opportunity to clean up the financial sector. When devaluation was finally forced on a reluctant government, it had a devastating impact on the financial and corporate sectors, both of which had large unhedged foreign-currency exposures. As they desperately 'scrambled for cover', purchasing foreign exchange to hedge their open positions, they only pushed the baht down further. This further undermined confidence in the currency, whose continuing depreciation aggravated the financial damage in a vicious destabilising spiral. The government's failure to adopt a credible alternative monetary anchor did little to assure investors that it had a consistent strategy for halting the deterioration. And the central bank, having exhausted its reserves, had no means with which to intervene. In retrospect, everyone now sees that it would have been better to move earlier, more gradually and more smoothly in the direction of greater exchange rate flexibility.

In contrast, Indonesia and Malaysia, among others, did adjust their exchange rates, introducing greater flexibility following the outbreak of the Thai crisis, while South Korea had operated a more flexible exchange rate for some time. Their cases remind us that exchange rate flexibility is no panacea. Large exchange rate changes were introduced in circumstances where severe financial-sector weaknesses had been allowed to develop. In some cases, these changes took place at the end of a long period of pegging during which the

authorities had denied all intention of allowing the rate to vary. Changing horses in mid-stream undermined confidence in the credibility and consistency of policy. Moving when capital had already begun flowing out hardly inspired confidence.

In addition, the authorities in these countries hesitated to use interest rates to stem the currency's fall and to signal their adoption of a clear alternative monetary strategy. Indonesia eased interest rates in August and September in the face of intense speculative pressure. Korea refrained from significantly raising interest rates until late December, and the congress did not pass a financial-sector reform law which would have granted the central bank significant operational independence. Malaysia waited even longer to raise interest rates and pursued policies of artificially supporting the stock market which were not consistent with monetary, price and exchange rate stability. In contrast, Singapore, where the commitment to low inflation was credible and long standing and did not rest on the exchange-rate anchor alone, escaped most of these difficulties.

Recent Asian experience thus illustrates the two core points of my lecture: first, the benefits of moving to greater exchange rate flexibility before the crunch comes; and second, that this transition must be done right.

5. Conclusion

Let me conclude with a story. In August of 1992, I am told, Bill Robinson, Norman Lamont's second in command at the U.K. Treasury read a book about the interwar monetary and financial crisis entitled *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939*. One of the author's main conclusions was that currency devaluation had been the key to economic recovery in the 1930s. Robinson came away convinced that sterling's days in the ERM were numbered and that Britain would be better off if it anticipated the inevitable and devalued the pound. Having completed all 448 pages, I am told, he brought the book to the Chancellor on the 26th of August and urged its argument upon him. But as fate would have it, this was the same day when Lamont had just announced that he wanted to remove any 'scintilla of doubt' about the government's intentions, and that he and the government were 'going to maintain sterling's parity and . . . do whatever is necessary' (Stephens 1996, p.226). Having gone out on this limb, the Chancellor could hardly reverse his position. One can only speculate – double entendre intended – about how British macroeconomic history would have been different had the country developed a coherent exit strategy before the fact. (One might also infer from this episode that it is not necessarily best to read all books to the end.)

International Monetary Fund

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