

# **Should Gold-Exporters Peg Their Currencies to Gold?**

A study for the World Gold Council

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## **Summary**

The debate over the best choices of monetary standards and exchange rate regimes for developing countries is as wide open as it has ever been. On the one hand, the big selling points of floating exchange rates – monetary independence and accommodation of terms of trade shocks – have not lived up to their promise. On the other hand, proposals for credible institutional monetary commitments to nominal anchors have each run aground on their own peculiar shoals: Rigid pegs to the dollar are dangerous when the dollar appreciates relative to other export markets. Money targeting doesn't work when there is a velocity shock. CPI targeting is not viable when there is a large import price shock. And the gold standard fails when there are large fluctuations in the world gold market.

Or does it? For most countries, a peg to gold translates extraneous fluctuations in world gold market conditions into needless fluctuations in local monetary conditions. But what about a country that happens to be specialized in the production of gold? For such a country, a depreciation of the currency when there is a fall in the world gold price is not an extraneous disturbance, but is precisely what is wanted. The real depreciation of the local currency stimulates production and export of gold and other commodities, just at the time when world market conditions are negative. The resulting amelioration of lost export revenue reduces the chance of a balance of payments crisis. The gold peg thus “hard-wires” the accommodation of terms of trade shocks that floating rates promise in theory but deliver only imperfectly in practice. The gold exporter gets the best of both the fixed and floating worlds: a nominal anchor and automatic adjustment to terms of trade shocks.

Only a small number of African countries have a ratio of gold to total goods exports as high as 40 %. (Over the period 1979-1996, Burkino Faso's exports of gold averaged 40% of merchandise exports, according to IMF statistics. More recently, in 1997, Ghana and Mali registered shares almost that high.) But the same idea could be applied to other commodities. Nigeria, Venezuela and Ecuador could peg their currencies to the price of oil. Ethiopia could peg its currency to the price of coffee. And so on. A country that exports a variety of mineral products could peg its currency to a corresponding basket of prices.

This study explores the idea that countries specialized in the export of gold or some other commodity could peg their currency to that commodity. (It is possible that this proposal would require a change in the IMF Articles of Agreement.)

The paper begins with a review of the issues. It then turns to a set of counterfactual experiments, as follows. For each of a list of gold-producing countries, what would have happened, over the last 30 years, if it had pegged its currency to gold, as compared to the dollar, yen, or mark, or as compared to whatever it actually did? We compute what would have happened to the price of gold in local terms under each of these scenarios. With very simple assumptions about elasticities, we then simulate what would have happened to total exports, under each scenario. With further simplifying assumptions, we also simulate what would have happened to such indicators of financial health as debt/GDP. In addition to looking at gold and gold-exporters, we also examine oil, silver, copper, aluminum, platinum, wheat and coffee, and the countries that are specialized in producing them.

An example illustrates. Imagine that Argentina, instead of following the convertibility plan that during 1991-2001 tied the peso to the US dollar, had pegged its currency to the price of a commodity such as wheat. Then the peso would have automatically depreciated in the latter half of the period instead of appreciating. Exports would have been boosted, and the Argentine crisis of 1999-2002 might never have occurred. The late 1990s were a time of severe financial pressure on most developing countries. Perhaps not coincidentally, it was also a time of weakness in commodity prices. If South Africa had been pegged to gold, Nigeria to oil, Jamaica to aluminum, Chile to copper, Colombia to coffee, Mauritania to iron ore, Mali to cotton, and Guinea-Bissau to peanuts (groundnuts), each of these countries would have seen their currencies depreciate at precisely the time when they most needed the boost to exports. This result would have obtained automatically – as is supposed to happen with a floating exchange rate -- and yet without having to give up the benefits of a nominal anchor.

Not all countries will benefit from a peg to their export commodity, and none will benefit in all time periods. One must go through the welter of simulation results developed in this paper to get a feeling for the variety of outcomes that is possible. Nonetheless, the results are suggestive. What they suggest is that, for countries specialized in a mineral or agricultural export commodity, the proposal that they peg their currency to that commodity deserves to take its place alongside pegs to major currencies and the other monetary regimes that countries consider.

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## Should Gold-Exporters Peg Their Currencies to Gold?

### A study for the World Gold Council

Jeffrey Frankel

Among the many travails of developing countries in recent years have been fluctuations in world prices of the commodities that they produce, especially mineral and agricultural commodities, as well as fluctuations in the foreign exchange values of major currencies, especially the dollar, yen, and euro. Some countries see the currency to which they are linked moving one direction, while their principal export commodities move the opposite direction. Immersion in stormy seas is likely to be the outcome, for someone who has a foot planted on each of two boats that are moving away from each other.

Consider the difficult position of Argentina, the victim of the worst emerging market financial crisis of 2001. As is well-known, Argentina's "convertibility plan," a rigid currency board, was very successful at eliminating very high inflation rates when it was first instituted in 1991, but later turned out to be unsustainably restrictive. Perhaps it would have been impossible in any case to obey constraints as demanding as the straightjacket of the currency board. But Argentina's problems in the late 1990s became especially severe because the link was to a particular currency, the US dollar, that appreciated sharply against other major currencies, beginning in mid-1995. At the same time, the market for Argentina's important agricultural export products (wheat, meat, and soybeans), declined sharply. Thus the declines in the prices of these commodities expressed in terms of dollars were particularly dramatic. The combination led directly to sharp increases in the ratio of debt to exports. Although the particular strong dollar episode was not predictable when the currency regime was adopted in 1991, the likelihood that large swings of this sort would eventually occur was predictable. This is because the correlation is low between the value of the dollar and the value of commodities (expressed in some common numeraire). It was only a matter of time until they went sharply in opposite directions.<sup>1</sup>

Argentina's dire difficulties have encouraged some to reconsider whether a currency board is a good idea after all (and others to wonder if Argentina should go all the way to full dollarization). But perhaps more thought should be given to *what* anchor the peso has been pegged to, rather than the tightness of the peg.

Consider on the other hand, Chile, a country where exports of metals, particularly gold and copper, are important. World prices of these products fell sharply in 1997.

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<sup>1</sup> The late 1990s were in some sense a replay of the early 1980s. A major reason for the international debt crisis that surfaced in 1982 was the combination of an appreciating dollar with weak world market conditions for the commodities exported by developing countries. (E.g., Cline, 1984; Dornbusch, 1985.)

The decline in prices was particularly strong when expressed in terms of dollars, for the same reason we have just seen: the dollar appreciated between 1995 and 1997. But, while the strong dollar was wreaking havoc on Argentina, Thailand, and other countries linked to the dollar, Chile was in a much better position. The Chilean peso was linked to a basket of currencies (dollar, yen, mark), and so automatically depreciated against the dollar. As a consequence, the adverse effects on its exports and its debt ratios was much less severe than the effects suffered by the dollar peggers.<sup>2</sup>

The advantages and disadvantages of various exchange rate regimes -- fixed versus floating as well as various other places along the spectrum -- are far too numerous to be readily captured and added up in a single model. The academic literature is very large. Part I of this paper will review the arguments briefly.

Less thoroughly explored is a more finite question: conditional on the decision to peg (with whatever degree of firmness) to a particular anchor, what difference does it make what that anchor is, whether it is (1) one currency such as the dollar, versus (2) another currency such as the yen, versus (3) a basket of currencies, versus (4) one commodity like gold, versus (5) a basket of commodities?

Monetary theorists have in the past emphasized a particular argument in favor of regimes that fix the value of money: as a means for the central bank to establish a credible commitment against inflation. This argument usually leaves out the question whether one means of fixing the value of the money is superior to another. It is as if it doesn't matter whether the anchor is the dollar or the Swiss franc or gold, or any other stable currency or commodity. The present study argues that the choice of anchor can make an important difference. Lithuania can get into trouble if it links its currency to the dollar, when most of its trade is with Europe; the euro would be better, because so much of Lithuania's trade is with the European Union. Argentina might be better off pegging to a basket of foreign currencies, or a basket of agricultural commodity prices, than pegging to the dollar. Ghana might be better off pegging to gold. Chile might be better off pegging to copper.

The questions to be examined in this study are as follows:

*What is the appropriate exchange rate regime for a country that is specialized in a particular mineral or agricultural commodity, such as gold or oil? What are the arguments in favor (and opposed to) a gold peg, reconsidered from the viewpoint of an individual gold-producing country? What about other mineral commodities?*

*For each of a list of major developing countries (especially producers of gold or other commodities), how would its export competitiveness and financial health have been affected over the last twenty years by alternative currency pegs: to gold, to other commodities, to the dollar, to the euro, or to the yen, as opposed to the currency regime*

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<sup>2</sup> To be sure, Chile followed better policies than other countries in many other respects as well. To begin with, its exchange rate regime was not a tight peg to its anchor (the weighted basket), but rather a band that moved on either side of the central parity. Even that regime was abandoned for still more flexibility in September 1999.

*that it actually followed? (Measures of financial health include ratios of debt/GDP, debt/exports, debt service/exports, and reserves/imports.)*

## **I. Pros and Cons of Different Exchange Rate Regimes**

Much has been written on the arguments for fixed exchange rates, versus floating exchange rates, versus intermediate alternatives.<sup>3</sup> We summarize the arguments briefly here, though elaborating on the nominal anchor argument for fixing the value of a currency.

### **Arguments for Flexible Exchange Rates**

There are a variety of advantages to flexible exchange rates: allowing the central bank to follow a counter-cyclical monetary policy (even with internationally integrated financial markets), automatic accommodation of terms of trade shocks, giving the government lender-of-last-resort capacity to rescue failing banks and the revenues from seignorage, and avoiding the damaging speculative attacks that currency pegs have been prone to in recent years. Of these, monetary independence has traditionally been considered the most important. But the last few decades have seen widespread disillusionment, both among academics and practitioners, with the proposition that governments are in practice able to use discretionary monetary policy in an intelligent and useful way.<sup>4</sup> This is particularly true in the case of developing countries. As a consequence, the trend in the 1990s was away from government discretion in monetary policy and toward the constraints of nominal anchors, which are discussed below, and central bank independence.

The argument that floating exchange rates automatically accommodate adverse movements in world market conditions has held up better. Some have argued, for example, that Australia and Singapore were the two Asian/Pacific countries to come through the 1997-98 Asian crisis in relatively good shape because their currencies were free to depreciate automatically in response to the deterioration of their export markets. Canada and New Zealand, like Australia, are said to be commodity-exporting countries with floating currencies that automatically depreciate when the world market for their export commodities is weak.<sup>5</sup> Still, floating rates do not always work this well.

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<sup>3</sup> Some of the classics are Friedman (1950), Johnson (1969), and Mundell (1961). Recent surveys of the arguments appear in Edwards (2002), Eichengreen (1994), and Frankel (1999).

<sup>4</sup> The problem may lie with lack of sincere aversion to inflation on the part of central bankers (e.g., Barro and Gordon, 1983; Rogoff, 1985, 1987), or with the skepticism of international investors (e.g., Hausmann, Gavin, Pages-Serra, and Stein, 1999).

<sup>5</sup> E.g., Chen and Rogoff (2002).

## **Arguments for Fixed Exchange Rates**

There are also a variety of advantages to fixed exchange rates: facilitating international trade and international investment by reducing transactions costs and exchange risk premia, avoiding the speculative bubbles that floating exchange rates seem occasionally to experience, and forswearing competitive depreciation or competitive appreciation. But in recent decades, the leading argument for firmly fixing exchange rates is as a credible commitment by the central bank, to affect favorably the expectations of those who determine wages, prices, and international capital flows by convincing them that they need not fear inflation or depreciation. The desire for a credible commitment to a stable monetary policy arose as a reaction to the high inflation rates of the 1970s, which in the 1980s reached hyperinflation levels in a number of developing countries. But fixing the value of the domestic currency in terms of foreign currency is not the only way that a country can seek a credible institutional commitment to non-inflationary monetary policy. Fixing the value of the currency in terms of gold is another way to seek such credibility – the classic argument for the gold standard. And there are other ways as well.

## **The Argument for a Nominal Anchor**

A gold standard is one of a number of possible nominally anchored monetary regimes. Others include monetarism, inflation targeting, nominal income targeting, and currency boards or other firm exchange rate pegs. In each case, the central bank is deliberately constrained by a rule setting monetary policy so as to fix a particular magnitude – the price of gold, the money supply, the inflation rate, nominal income, or the exchange rate. Monetary policy is automatically tightened if the magnitude in question is in danger of rising above the pre-set target, and is automatically loosened if the magnitude is in danger of falling below the target. The goal of such nominal anchors is to guarantee price stability.

Sovereign governments have been debasing their currencies through excessive money creation and inflation since the invention of fiat money. Inflationary episodes were a particular concern of the 20<sup>th</sup> century. Why do governments go down this road? One motive is seignorage: governments get to spend the money that they print. A government that feels it needs to spend a certain amount, e.g., to pursue military endeavors, and cannot finance it by taxation or borrowing, may instead turn to the alternative of printing money. The other motive is to stimulate the national economy. A monetary expansion can have the effect in the short run, before it is fully reflected in inflation, of reducing real interest rates and thus stimulating national output and employment.

The advantages of monetary expansion eventually wear off, however. As public expectations adjust to higher levels of inflation, so does the behavior of firms, investors, and workers. The government must print money continuously just to keep with expectations. In the long run, only the disadvantages of high rates of inflation remain.

Many central banks would like to convince their citizens to expect no inflation. Without high expectations of inflation, workers will ask for lower wages, firms will accept lower prices, and investors will demand lower interest rates. As a consequence,

the central bank can achieve any given level of output and employment with a low rate of money creation and inflation. The question is how to convince the public to lower its expectations of inflation. The day is past when it is enough for the central bank to proclaim its firm intention to pursue a low rate of money creation and inflation. Such announcements are not necessarily considered credible.

Governments can achieve credibility by being seen to tie their hands in some way so that in the future they cannot follow expansionary policies even if they want to. Otherwise, they may be tempted in a particular period (such as an election year) to reap the short-run gains from expansion, knowing that the major inflationary costs will not be borne until the future. A central bank that would like to constrain itself, so that in the future it can resist the political pressures and economic temptations of expansion, is like Odysseus in the Greek myth. As his ship was approaching the rocks from where the seductive Sirens lured weak-willed sailors to their doom, Odysseus had his sailors tie him to the mast.

How can a central bank make a binding commitment to refrain from excessive money creation? It can tie its hands by a rule, a public commitment to fix a nominal magnitude. As already noted, popular magnitudes for this nominal magnitude, or anchor, include the money supply, the price level or inflation rate, the price of gold, or of a basket of commodities, nominal GDP, and the exchange rate.

Preventing excessive money growth and inflation is the principle “pro” argument for fixing the price of gold or some other nominal anchor. What, then, are the “con” arguments? The overall argument against the rigid anchor is that a strict rule prevents monetary policy from changing in response to the needs of the economy. The general problem of mismatch between the constraints of the anchor and the needs of the economy can take three forms: (1) loss of monetary independence, (2) loss of automatic adjustment to export shocks, and (3) extraneous volatility. First, under a free-floating currency, a country has monetary independence. In a recession, when unemployment is temporarily high and real growth temporarily low, the central bank can respond by increasing money growth, lowering interest rates, depreciating the currency, and raising asset prices, all of which to mitigate the downturn. Under a pegged currency, however, the central bank loses that sort of freedom. It must let recessions run their course. The second point is that even if the central bank lacks the reflexes to pursue a timely discretionary monetary policy, under a floating exchange rate a deterioration in the international market for a country’s exports should lead to an automatic fall in the value of its currency. The resulting stimulus to production will mitigate the downturn even without any deliberate action by the government. Again, this mechanism is normally lost under a rigid nominal anchor.

A third consideration makes the pegging problem still more difficult. If a country has rigidly linked its monetary policy to some nominal anchor, exogenous fluctuations in that anchor will create gratuitous fluctuations in the country’s monetary conditions that may not be positively correlated with the needs of that particular economy.

*Each candidate for nominal anchor has its own vulnerability*

Each of the various magnitudes that are candidates for nominal anchor has its own characteristic sort of extraneous fluctuations that can wreck havoc on a country's monetary system.

- Under a *monetarist* rule, fluctuations in the public's demand for money or in the behavior of the banking system can directly produce gratuitous fluctuations in the interest rate and in thereby in the real economy. For example, in the United States, a large upward shift in the demand for money around 1982 convinced the Federal Reserve Board that it had better abandon the money growth rule it had adopted two years earlier, or else face a prolonged and severe recession. (Such fluctuations in money demand are velocity shocks.)
- To some, the novel idea of pegging the currency to the price of the export good, which this study puts forward, may sound similar to the current fashion of *targeting the inflation rate* or price level.<sup>6</sup> But the fashion, in such countries as the United Kingdom, Sweden, Canada, New Zealand, Australia, Chile and Brazil, is to target the CPI. A key difference between the CPI (or GDP deflator) and the export price is the terms of trade. When there is an adverse movement in the terms of trade, one would like the currency to depreciate, while price level targeting can have the opposite implication. If the central bank has been constrained to hit an inflation target, positive oil price shocks (as in 1973, 1979, or 2000), for example, will require monetary tightenings in an oil importing country. The result can be sharp falls in national output. Thus under rigid inflation targeting, supply or terms-of-trade shocks can produce unnecessary and excessive fluctuations in the level of economic activity. The need for robustness with respect to import price shocks is used to argue the superiority of nominal income targeting over inflation targeting.<sup>7</sup> (A practical argument against nominal income targeting that is important for developing countries is that the data are often available only with a delay of one or two years. But targeting the price of domestically-produced goods would have the same advantage of robustness with respect to import price shocks that a CPI target lacks, without the data problems.)
- Under a *gold standard*, the economy is hostage to the vagaries of the world gold market. For example, when much of the world was on the gold standard in the 19th century, global monetary conditions depended on the output of the world's gold mines. The California gold rush from 1849 was associated with

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<sup>6</sup> Among many possible references are Svensson (1995) and Bernanke, et al. (1999).

<sup>7</sup> E.g., Frankel (1995) demonstrates the point mathematically, and gives other references on nominal income targeting. One could apply this same theoretical apparatus, taken from Rogoff (1985, 1987), to demonstrate the conditions under which fixing the price of the export commodity would be superior to alternatives such as fixing the CPI.

a mid-century increase in liquidity and a resulting increase in the global price level. The absence of major discoveries of gold between 1873 and 1896 helps explain why price levels fell dramatically over this period (53 percent in the United States and 45 percent in the United Kingdom), inflicting hardship, for example, on American farmers. In the late 1890s, the gold rushes in Alaska and South Africa were each followed by new upswings in the price level of similar magnitude. Thus the system did not in fact guarantee price stability.<sup>8</sup>

- One proposal is that monetary policy should *target a basket of basic mineral and agricultural commodities*. The idea is that a broad-based commodity standard of this sort would not be subject to the vicissitudes of a single commodity such as gold, because fluctuations of its components would average out somewhat.<sup>9</sup> If the basket reflected the commodities produced and exported by the country in question, the proposal could work well. But for a country that is a net importer of oil, wheat, and other mineral and agricultural commodities, such a peg gives precisely the wrong answer in a year when the prices of these import commodities go up. Just when the domestic currency should be depreciating to accommodate an adverse movement in the terms of trade, it appreciates instead. Brazil should not peg to oil, Kuwait should not peg to wheat, and Korea should not peg to either.
- Under a *fixed exchange rate*, fluctuations in the value of the particular currency to which the home country is pegged can produce needless volatility in the country's international price competitiveness. For example, the appreciation of the dollar from 1995 and 2001 was also an appreciation for whatever currencies were linked to the dollar. Regardless the extent to which one considers the late-1990s dollar appreciation to have been based in the fundamentals of the US economy, there was no necessary connection to the fundamentals of smaller dollar-linked economies. The problem was particularly severe for some far-flung economies that had adopted currency boards over the preceding decade: Hong Kong, Argentina, and Lithuania. Dollar-induced overvaluation was also one of the problems facing such victims of currency crisis as Mexico (1994), Thailand and Korea (1997), Russia (1998), Brazil (1999) and Turkey (2001), even though none of these

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<sup>8</sup> Cooper (1985) or Hall (1982). Proponents reply that the sort of price stability that is most important for efficient long-term economic planning by individuals is not simply minimizing short run variability, but rather the guarantee against large inflationary episodes that a gold standard is designed to offer. On the classical gold standard, see also Bordo and Schwartz (1997) and papers in Eichengreen (1985).

<sup>9</sup> A "commodity standard" was proposed in the 1930s – by B. Graham (1937) – and subsequently discussed by F. Graham (1941), Keynes (1938), and others. It was revived in the 1980s, as a less narrow version of proposals to return to a gold standard – e.g., Hall (1982).

countries had formal rigid links to the dollar, and indeed only Thailand had had a peg to the dollar in the two years preceding the crisis even in de facto terms. It is enough for the dollar to exert a large pull on the country's currency (relative to the weight of the United States in the country's exports) to create strains. The loss of competitiveness in non-dollar export markets adversely impacts such measures of economic health as real overvaluation, exports, the trade balance, and growth, or such measures of financial health as the ratios of current account to GDP, debt to GDP, debt service to exports, or reserves to imports.

To recap, each of the most popular variables that have been proposed as candidates for nominal anchors is subject to fluctuations that will add an element of unnecessary monetary volatility to a country that has pegged its money to that variable: velocity shocks in the case of M1, supply shocks in the case of inflation targeting, fluctuations in world gold markets in the case of the gold standard, and fluctuations in the anchor currency in the case of exchange rate pegs.

This study will argue that for those small countries that want a nominal anchor and that happen to be concentrated in the production of gold, a peg to gold may in fact make perfect sense. For them fluctuations in the international value of their currency that follow from fluctuations in world gold market conditions would not be an extraneous source of volatility. Rather they would be precisely the sort of movements that are desired, to accommodate exogenous changes in the terms of trade and minimize their overall effect on the economy. In these particular circumstances, the automatic accommodation or insulation that is normally thought to be the promise held out only by floating exchange rates, is instead delivered per force by the pegging option. Similar reasoning applies for countries that happen to be concentrated in the production of some other agricultural or mineral commodity. A country that exports a variety of commodities could peg to a basket of their prices.

Consider further the case of pegs to the dollar or other major currencies. Each of the currency crisis victims listed above (1994-2001) has since abandoned its links to the dollar or to the basket that included the dollar -- as have Chile, Colombia and others -- in favor of greater flexibility. Nevertheless, they continue to exhibit a fear of floating.<sup>10</sup> Meanwhile, Ecuador has dollarized, and some economists urge that other countries as well should move in this direction. Some argue that either corner -- free floating or firm fixing -- is in general superior to the intermediate regimes, but others argue that the intermediate regimes are still often appropriate. Few countries are comfortable that they have found the right answer. Alternative suggestions are still welcome.

The aim of the present study is not to continue the extensive debate on the relative desirability of firm pegs versus free floating versus various intermediate regimes. Rather the aim is to address the question: given a degree of commitment by country to fix the value of its currency, what anchor should it use? This question is particularly well

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<sup>10</sup> In other words, even though they officially classify themselves as floating, in fact they intervene frequently to stabilize their exchange rates. Calvo and Reinhart (2000).

illustrated not by those who have abandoned pegs for enhanced flexibility, nor even by those who have moved in the opposite direction, but rather by those (few) who have moved from one rigid peg to another. Lithuania – while retaining a currency board arrangement – responded to the difficulties created by the late-1990s appreciation of the dollar by switching from a dollar anchor to the euro. Argentina also debated some sort of switch. Economy Minister Cavallo, in 2001 before his resignation and the abandonment of the convertibility system, had announced an eventual move to a currency board with an anchor defined as a basket of one half dollar and one half euro. In both cases, a large part of the motivation was an overvaluation stemming from the late-90s appreciation of the dollar.<sup>11</sup>

This study differs from most research on currency regimes by giving consideration to a different sort of alternative: using gold or other commodities as the anchor. It has been many years since any country pegged its currency to gold or silver. (Proposals for pegs to a more complete basket of commodities, such as Graham (1937) or Hall (1982) have never been tried.) As mentioned, those who in recent times have proposed a gold peg, or broader commodity standard, generally have in mind the United States or a few other large other industrialized countries leading the way, with other countries following suit. It is intended as a global monetary standard, as it once was.<sup>12</sup> But this study instead considers the possibility of pegging to gold or other commodities from the standpoint of a single small country.

To cite the problems created by dollar appreciation is not to say that all countries should move away from the dollar toward something else. For one thing, the strong dollar of 1996-2001 is a transitory phenomenon. From 1988 to 1995 the dollar was weak, and it will no doubt one day be weak again. When that happens, it will be the countries that are pegged to the euro that will lose competitiveness. The relevant question is the choice of regime for the longer term, when it is not known which currencies will be weak and which strong, but is only expected that swings in both directions will eventually occur.

### **How to Weigh up the Costs vs. the Benefits**

No single exchange rate regime is appropriate for all countries. The right choice for any country depends on its particular circumstances. These propositions apply not only to the decision whether to peg or float, but also to the decision regarding to what currency a pegging country should peg.

We briefly review two frameworks for adding up the costs and benefits of alternative regime choices facing a country. The emphasis here is now on the choice

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<sup>11</sup> Although Turkey's link to the appreciating dollar in 2000 (ending in the crisis of January 2001) was far weaker than a currency board, some would identify it as another casualty to an unfortunate mismatch between the composition of the currency peg and the composition of trading partners .

<sup>12</sup> In the course of the 19<sup>th</sup> century, first Britain, and then one country after another decided to peg its currency to gold, until the gold standard was virtually global by 1880.

between one currency or commodity peg versus another, not just on pegging versus floating. In a world where the prices of the major currencies and commodities are all fluctuating vis-à-vis each other, to peg to any one of them of course means to float against the others.

### ***Optimum Currency Area criteria***

The *traditional OCA criteria* weigh the costs and benefits mainly as they pertain to trade and cyclical fluctuations. The advantage of pegging to the currency of a particular country is that it eases trade with that country. This advantage will be large if trade with that particular partner is naturally large, for example if it is a large neighbor (as shown by the so-called gravity model of bilateral trade). The disadvantages have to do with the constraint imposed by subordinating one's monetary policy to that of the other country. The domestic country loses the ability to respond to asymmetric shocks – cyclical fluctuations that are imperfectly correlated with those of the other country. The disadvantage of fixing to the partner will be small if asymmetric shocks are rare, or if the domestic country has alternative ways of adjusting to the shock other than monetary expansion or devaluation. (Such alternatives include ease of migration of labor across borders, between countries that are at different points of the business cycle.)

Asymmetric shocks are more likely to be rare if the two countries produce similar commodities or if they trade a lot with each other.<sup>13</sup> Thus two countries that have strong trade links (or strong links of labor mobility) are more likely to find that the advantages of fixing the exchange rate between them outweigh the disadvantages of giving up monetary independence.

An analogous proposition holds for the commodity composition of exports. Fixing the value of one's currency in terms of a commodity like gold carries the advantage of convenience and risk reduction if that commodity is a major product of the country. At the same time, the disadvantages of giving up monetary independence are less if the anchor is the price of the major export commodity. A period when the world market for the country's product turns down is precisely the time when it needs a real depreciation of its currency to mitigate the loss in demand; such a real depreciation will take place automatically if the currency is pegged to the price of the commodity in question.

### ***Modern credibility criteria***

The traditional Optimum Currency Area framework has more recently been supplemented by an additional set of criteria to determine whether a particular country is well suited to the constraints of a fixed exchange rate. A response to the experience of the crises of the 1990s, the new criteria have to do with stability in financial markets and credibility in the eyes of speculators, rather than stability in goods markets and credibility in the eyes of price-setters. Some of the criteria are determinants of the potential benefits to importing credibility. Countries that have a desperate need to import

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<sup>13</sup> Not everyone agrees with this proposition. But it is supported in Frankel and Rose (1998).

monetary stability include those with a history of hyperinflation, those with an absence of credible public institutions, or those with large exposure to nervous international investors. Other criteria concern “initial conditions” that tend to reduce the cost to a country of giving up its currency: an already-high level of private dollarization, high pass-through of exchange rate changes to output prices, and access to an adequate level of reserves.

One bottom line is that countries that are at relatively early stages of development, are in transition from socialism, are located in unstable parts of the world, or are newly independent, are good candidates for firmly pegged currencies, particularly if they want to make use of international financial markets. The reason is that they face greater skepticism from international investors than do rich well-established countries, and stand to benefit more by importing monetary stability from abroad.

### **Regime Choice for a Country Specialized in Gold or Other Commodities**

If a country that is dependent on a particular export commodity, what exchange rate policy should it follow? Surprisingly, there is no standard textbook prescription for such a country, even as between fixed and floating exchange rates. On the one hand, the often-cited advice of Kenen (1969) is that only if a country is sufficiently diversified in the production of different commodities should it float, implying that a country where production is concentrated should peg. On the other hand, another famous prescription holds that a country where external shocks are large should float, to insulate itself against them. This advice would seem to contradict the Kenen line, in that the overall magnitude of external shocks will be larger in a specialized economy, whereas they will tend to cancel out in a diversified economy. A good reconciliation of the two viewpoints is to distinguish between the degree to which exports (or tradable goods) are concentrated in a single commodity and the importance of exports overall (or tradable goods overall) in the aggregate economy. Both ratios contribute to the ratio of exports of the particular commodity to aggregate GDP:  $(\text{Commodity } j / \text{Total exports}) * (\text{Total exports} / \text{GDP}) = (\text{Commodity } j / \text{GDP})$ . Nevertheless, they can have opposite implications for the desirability of fixed versus floating exchange rates. To the extent exports are concentrated in a single commodity, or a few commodities that are highly correlated in price, then external shocks are large and floating may be desirable. This is especially true if the world price of the commodity or commodities is highly variable. But to the extent that exports or tradeables are large in GDP, the advantages of pegging are large.<sup>14</sup>

#### ***The case for the gold peg reconsidered for a gold exporter***

The idea of a gold peg is more popular at some times than others. In the early 1980s, there were proposals for a return to the gold standard, often taking the form of a proposal that the United States peg the price of gold unilaterally with other countries then joining in as they see fit. The motivation was price stability, but also, in part, nostalgia

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<sup>14</sup> McKinnon (1963).

for the simpler days before 1914, or even before 1971. The current period is not one of those in which gold standard proposals are particularly popular. In part this is because inflation has not been a major concern in recent years. In part it is because some consider the intellectual case for a global gold standard to be weak. Why should the world economy make itself hostage to the vagaries of the world gold market?

There is a much stronger, but surprisingly neglected, case to be made in favor of small individual countries for whom gold exports are a substantial source of income going on a gold peg. Many small open economies are seriously considering given up monetary independence anyway. Some of them have already done so, from the currency boards of Hong Kong and Eastern Europe to the dollarizers of Ecuador and the Caribbean. For such countries, warnings about gold becoming a monetary straitjackets are moot. They have decided to live in straitjackets anyway. In this context, the question is what straitjacket to choose. Even in the case of anchors to currencies, much less is written on how to choose the anchor currency, than on the primary question of whether to anchor at all. The idea of a small country anchoring to the price of its major export has barely been explored.

When one comes to think of it, it is striking how the standard arguments against a gold peg melt away for the special case of a gold-producing country. One venerable argument against a worldwide gold standard is the need for a reserve asset that grows gradually over time in supply. The fear was that if gold were the sole reserve asset, the supply would not grow fast enough to keep pace with long-term growth in potential gross world product, and the resulting squeeze on reserves would create a global drag on economic growth. This is why dollars became the global supplementary reserve asset during the postwar period (even though the dollar was not given this formal role at Bretton Woods).

From the viewpoint of an individual country that is considering pegging its currency, it is no more difficult to add to reserves gradually over time by earning gold through a balance of payment surplus than by earning dollars. Indeed, a gold producer has the alternative of earning some of its gold reserves by domestic mining, rather than having to pay seignorage to the United States, which may be galling to some countries. This may be too literal an interpretation of how the gold peg would work. The question of the currency or precious metal in which a country chooses to peg its currency is logically distinct from the question of the currency or precious metal in which it chooses to hold its reserves. After all, the country can export gold and holds its reserves in the form of dollars as easily as holding its reserves in the form of gold. And reserves held in the form of US treasury bills pay a higher interest rate than gold. But nevertheless, the pegging question and the reserve question tend in practice to go together. And there may be something “empowering” in the public mind of a gold-producing country to back its currency by gold.

For countries that are specialized in the production of commodities other than gold, analogous arguments might be made for a peg to the price of that commodity. To be sure, the arguments would never carry quite as much weight. There is something special about gold, in light both of its historical role and of the intrinsic characteristics that have qualified it for that role – storability, indestructibility, inelastic supply. (Silver

has a bit of the same “lustre,” but it happens that no countries are heavily specialized in the production of silver.) It is not likely that a peg to agricultural product prices, for example, could deliver quite the same hard-money credibility as a peg to a precious metal. But notwithstanding the special place of gold, for those commodities specialized in the production of other commodities, it is worth considering the broader idea of a commodity peg.

***Baskets of currencies and commodities for countries with diversified trade***

A majority of writings on the choice of exchange rate regime speak as if, to the extent that a country decides to commit to an exchange rate target, there is a unique currency to which it will peg. But, of course, in a world where the major currency are floating against each other, to peg to one is to float against the others. It may be clear that Estonia should peg to the euro and El Salvador to the dollar. But most countries, such as those in Africa and Asia, have trade that is heavily diversified with respect to trading partners. This is particularly true of most producers of mineral products. This suggests a strategy of pegging to a basket of a few major currencies, such as the dollar, euro, and yen.<sup>15</sup> In theory this should be just as credible as a peg to one. In practice, it may not be. A basket peg is in practice less transparent, less easily verified by the man in the street on a daily basis than is a simple dollar peg.<sup>16</sup>

Analogous considerations apply to the commodity composition of trade. For a country that is specialized in the production of gold or oil, pegging to gold or oil has some extra attractions. The mining companies are saved the trouble of incurring transactions costs and exchange risk in their daily operations. The credibility argument is strengthened, because the commitment to fix the price of gold is easily verified by the man in the street on a daily basis. But most countries, even among the minority who are specialized in mineral products, are not heavily specialized in a single product such as gold. (The oil producers are the most important exception.) For those who produce a variety of mineral products, like Australia, Bolivia, and some African countries, the logical answer is to peg to a basket of those commodities. But whether the same gains with respect to credibility and transactions costs could be reaped is an unexplored question.

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<sup>15</sup> Among many possible references on basket pegs are Takagi (1988) and Williamson (2001).

<sup>16</sup> Frankel, Schmukler and Servén (2000) argue that some of the credibility gains are lost when the peg is to a basket, as was Chile in the 1990s. Furthermore, recent empirical evidence suggests that a reduction in exchange rate variability has a far bigger effect on trade when there is a rigid fixing to the currency of an important bilateral trading partner (Rose, 2000; Frankel and Rose, 2002; Saiki, 2002). This suggests that gains in the promotion of bilateral trade and investment may also be lost by a basket peg.

## **II. The Counterfactual:** **What Would Have Happened Under Different Pegs?**

The remainder of this study will address the possible pegging policies of countries for whom gold is an important export commodity and also countries for whom oil, wheat, or a few other mineral or agricultural products are important export commodities. Our major criterion for whether gold or other commodities are important to the country in question is exports (we have also considered production) as a share of total exports of goods and services (we have also looked at merchandise exports alone, and total GDP). At this stage we concentrate mostly on low-income debtor countries. Thus the Persian Gulf countries, for example, are not included among the list of oil producers in whom we are interested. Nor are we interested in large countries such as the United States and Canada, for whom production of oil, gold or wheat may rank high in absolute terms, but low as a share of their economies. Thus some of the countries that appear here may not loom especially large in the world market for their particular commodity, even though the market for their particular commodity looms large in that country.

Our list of a dozen gold exporters is as follows:

1. Bolivia
2. Burkino Faso
3. Burundi
4. Fiji
5. Ghana
6. Guyana
7. Mali
8. Mongolia
9. Papua New Guinea
10. Peru
11. Rwanda
12. South Africa

Details regarding the choice of countries and their statistics are given in Tables Set 1 (the electronic version is available at [http://people.brandeis.edu/~smap/rank\\_price.html](http://people.brandeis.edu/~smap/rank_price.html)) or [http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank\\_price.html](http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank_price.html).<sup>17</sup>

### **How Would the Price of the Export Commodity Have Moved Under Alternative Pegs?**

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<sup>17</sup> Future research may add major emerging market countries that have experienced severe financial pressure in the 1990s. Already among the gold producers, South Africa and Russia qualify. Mexico, Indonesia, Ecuador, Colombia, Brazil, Argentina, Venezuela, and Chile are also among the other important emerging market countries that we have analyzed, as exporters of oil, wheat, coffee, or copper. But other crisis victims such as Thailand, Korea and Turkey have not yet been analyzed.

The hypothetical experiment goes as follows. For each of the countries on our list, it is easy to calculate what would have been its exchange rate against the yen and euro, and what would have been the local currency price of various commodities, if it had pegged to the dollar during the period 1970-2000, instead of following whatever exchange rate policy it actually followed. We can then compute what would have been the movements of the price of its major export in terms of local currency.<sup>18</sup> We can see whether the volatility of this relative price would have been higher or lower over these two decades under the dollar peg. This section discusses the simulated price paths under alternative currency policies; subsequent sections go on to look at implications for export performance.<sup>19</sup>

### *Gold prices*

The three countries that were most specialized in gold exporting averaged over the period 1979-1996, according to our figures, are Burkino Faso (40 % of goods exports), Ghana (17 %) and Papua New Guinea (15%). Mongolia and Guyana also rank high, particularly if gold exports are calculated as a percentage of all goods and services exports. Rwanda and Burundi also rank high in our figures, though the statistics might be affected by smuggling.<sup>20</sup> Bolivia, Fiji, Mali and Peru are other countries where gold exports are in the range of 3-10% of exports during this period. We have also added South Africa. (We have omitted Uruguay, Australia, Dominican Republic and Nicaragua, French Guiana, and Uzbekistan, though they are also candidates by one measure or another.<sup>21</sup>)

Figure 2 shows the nominal price of gold from the viewpoint of our gold-exporting countries. For each, the {dark black} line shows the actual price of gold on world markets, expressed in terms of local currency, that these countries encountered over the last three decades. The general pattern is as follows: sharp upward movements

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<sup>18</sup> The local price of the export good is one possible definition of the real exchange rate, if local wages and prices of non-traded goods are fixed in terms of local currency in the short run.

<sup>19</sup> The importance of particular export commodities to particular countries is shown in Table Set I; graphs of the computed commodity prices under alternative scenarios appear as Figure Set II; and statistics on simulated price variability are reported as Table Set III. They are available at either [http://people.brandeis.edu/~smap/rank\\_price.html](http://people.brandeis.edu/~smap/rank_price.html) or [http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank\\_price.html](http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank_price.html). (Appendices there give further details on how the computations were done.)

<sup>20</sup> They do not rank at all in Plowden and Wilde (1999).

<sup>21</sup> Statistics in Plowden and Wilde (2001b) suggest that gold exports from Mongolia and Papua New Guinea were higher in 1999 than during the average of our sample period, 1979-1996. Statistics in Plowden and Wilde (2001a) suggest that gold exports by Bolivia, Guyana, Nicaragua and Peru were higher in 1998 than during the average of our sample period. Gold is also now important to Kyrgyz Republic (in 2000) according to Plowden and Wilde (2002).

in the early 1970s and late 1970s, followed by a reversal of trend in 1980, with signs of an eight-year cycle over the last two decades. But the specifics depend on what is assumed about exchange rates.

Consider the example of one country where gold exports happen to be very important, Burkina Faso. Like most francophone countries in Western and Central Africa, this one is a member of the CFA franc zone, which means that its currency has normally been pegged to the French franc (and now to the euro), except for a devaluation in 1994. Compare the price of gold that Burkina Faso would have faced if it had been pegged to the dollar, compared to the price it actually experienced. The gold price increases in the 1970s would have been far sharper, as a consequence of devaluation and depreciation of the dollar; the country would have been hit by a decline in the early 1980s that it did not in fact experience, as a consequence of a strong dollar; and it would have missed an increase in 1994 that it in fact did experience, when the CFA franc devalued. If Burkina Faso had been pegged to either the yen or the mark, then the price of gold in domestic terms would have been more stable overall, because it would have avoided both the largest dollar swings of the 1970s and 80s and the CFA devaluation of 1994.

The upper panel of Table 2 reports the corresponding summary statistics for each of eight gold exporting countries. Several measures of volatility are reported: standard deviation, number of years in which the price would have deviated more than 10 per cent from the mean, percentage of years in which the price would have deviated more than 10 percent from the mean, etc. For Burkina Faso we see that volatility, for example as measured by the standard deviation, would have been somewhat lower if it had been pegged to the dollar, and lower still if it had been pegged to the yen or mark. Of course, if Burkina Faso had been on a gold peg, the volatility of the price of gold in terms of domestic currency would by definition have been zero, and the appropriate graph in Figure 2 would have shown a flat line.

Consider next the example of Papua New Guinea, where the currency (the kina) was tied to the dollar until the late 1990s, but is now classified as “independently floating.” The simulations shows that the gold price decline it suffered in 1980-82 would have been more moderate if it had been linked to the mark, as opposed to the dollar, because the dollar appreciated against the mark.. The decline in the price of gold in terms of the yen or mark was again more moderate during 1996-2000 than in terms of the dollar, when those currencies weakened against the dollar. But by then the New Guinea currency was free, and depreciating. As a result, the local price of gold did not fall in the late 1990s, but instead rose substantially.

Regardless the currency in terms of which the price of gold is expressed, it can be misleading to focus solely on the nominal price. Movements in the real price of gold are more important. They determine whether resources (meaning, in particular, capital and labor) inside the gold exporting country have an incentive to shift into the production of gold from other activities, or in the opposite direction. The rising price of gold in New Guinea in the late 1990s to some extent reflected a general inflation in the economy. To that extent, it did not provide a particular incentive for resources to shift into gold

production, because wages and prices in other sectors were rising as well. The same is true of South Africa throughout the 1980s and 90s. (South Africa is classified as floating.) If our goal is to evaluate the implications of alternative monetary regimes for international price competitiveness and international debt, we should focus on the real price of gold. That is, we should deflate by the general price level in the country in question.

The right column of Figure 2 shows the real price of gold for the same set of countries. Table 2 reports summary statistics on variability of the real price of gold [lower panel]. In all cases, variability is lower than reported for the corresponding measures in the upper panel, confirming that much of the movement in the nominal price of gold reflects movement in the general price level. But the question of interest in this table, whether pegging to a major currency would have stabilized the real price of gold in domestic terms, has a different answer in different cases.

The exchange rate path actually followed by South Africa looks better now; the real price of gold in the 1990s was at least as stable as would have occurred if the rand had been pegged to a major currency. The real price did not decline in 1994-95 as it would if the rand had been pegged to the (appreciating) yen or mark, nor did it decline as much in 1996-2000 as it would have if the South African currency had been more tightly linked to the (appreciating) dollar. Similarly, the real price of gold experienced by Burundi throughout this period was considerably more stable than it would have been if the currency had been pegged to a major currency. If pegged to the dollar, Burundi would have experienced a large upward trend in the 1970s, followed by a slow downward trend in the 1980s and 90s. Of eight countries, Ghana stands out in that the real price of gold was more variable than it would have been if the currency (the cedi) had been pegged to any of the major currencies (experiencing large declines in the mid-1970s and early 1980s, and a large increase during 1982-87).

Again, if any of these countries had had the stabilization of the price of gold as their overriding objective, they could have sought to peg it through monetary policy. But a fair comparison of the gold peg to the currency pegs will have to wait for the analysis of implications for exports and other economic variables below.

### *Oil prices*

Next we look at seven major oil exporters. In each, oil exports are a high percentage of goods exports: Nigeria 93%, Venezuela 54%, Ecuador 44%, Cameroon 33%, Indonesia 28%, Mexico 24% and Russia 14%. Given so many oil exporters to choose from, we have concentrated on those that have had international debt problems. Thus we have thus omitted some where oil constitutes more than 70% of goods exports (Libya, Saudi Arabia, Gabon, Iran, Oman), or more than 40% of GDP (Brunei, Qatar, and UAE), but that are mostly creditors rather than debtors.

The nominal price of oil tells a general story similar to the price of gold: sharp increases in 1974 and 1979, followed by declines in 1986 and 1998, and a pattern whereby the movements in terms of marks are a little less pronounced than the movements in terms of dollars. It is interesting that the volatility is so high when the oil price is expressed in terms of dollars, because OPEC supposedly sets the price in terms of dollars. Certainly oil is indeed invoiced in dollars. But the implication of these statistics

is that OPEC in fact does not succeed in stabilizing the price in terms of dollars on a yearly basis.

Many of these oil-exporting countries experienced occasional jumps in the domestic price of oil when they devalued, which they would not have experienced if their currencies had remained pegged: Nigeria in 1999, Indonesia in 1998 (when it responded to a financial crisis -- itself exacerbated by a weak world oil market -- thereby reversing what would otherwise have been a sharp fall in the domestic price of oil), and Russia in the early 1990s (when it was merely offsetting very high domestic inflation) and again in 1999 (when it achieved a major improvement in international competitiveness, again in response to the 1998 financial crisis). On the other hand, the Indonesian rupiah and Ecuadorian sucre, for example, appreciated against the dollar in 1980 (the strong world oil market in these years perhaps contributed to the strength of their currencies); the result is that they experienced a smaller increase in the price of oil than they would have if they had pegged to a major currency. For each of the seven oil-exporting countries the domestic nominal price of oil would have been much less variable if they had been pegged to one of the three major currencies. Needless to repeat, the variability would have been lower still if they had sought as a matter of deliberate policy to stabilize the value of their currency in terms of oil.

Some of these countries experienced substantial inflation: Ecuador, Venezuela, Mexico in the 1980s, Russia in the early 1990s, and Nigeria increasingly over time. Again, the conversion from nominal to real is necessary. A look at the real price of oil shows that the world market declines of 1986 and 1998 fully reversed the real price increases of 1974 and 1979.

Nigeria's erratic monetary history is evident; it would have experienced a more stable price of oil if it had pegged its currency to either the dollar, yen or mark. The fall in world oil prices in 1998 hit Nigeria hard, contributing to its dire international position, which in turn produced a collapse in the currency and much higher local-currency oil price the subsequent year.

### *Prices of other minerals*

The world market in silver, as in gold, peaked in 1980, but the rise during 1978-1980 was even sharper, as was the subsequent decline. This time the price was most volatile when expressed in terms of yen. The only two countries where silver constitutes more than two per cent of exports and more than 1/3 of one percent of GDP are Bolivia and Peru. Both countries experienced hyperinflations -- one ending in the mid-1980s in the case of Bolivia and another ending in the early 1990s in the case of Peru -- so that a comparison of nominal prices over the span from the 1970s to the 1990s is not meaningful. Turning to the statistics on the real price of silver, we see that Peru would have reduced variability by pegging to the yen, and even more by pegging to the dollar or mark. Bolivia on the other hand experienced less variation in the real local price of silver than it would if it had been pegged to any of the major currencies.

Swings in the world copper market have tended to be somewhat more frequent, but not quite as large in amplitude, with peaks in 1974, 1980, 1989, and 1995. Each was followed by a price decline; the decline in 1975 was particularly severe and caused a

recession in Chile, for example. The variability is high for the price of copper expressed in yen, particularly in the 1970s. The 1973-75 rise and fall in the world copper price happened to coincide with a cycle of depreciation of the yen, followed by appreciation.

Our two copper exporters are Chile and Mongolia. Both experienced inflation during the sample period that was too high to make the figures on nominal price variability useful. Chile succeeded in beating inflation, by means of exchange rate targets, during the course of the 1980s, after which it switched to a basket of major currencies in the 1990s (made flexible by bands, that were progressively widened, until a move to floating in 1999). The figures on variability in the real price of copper appear to show that Chile did slightly better with its actual exchange rate policy than it would have from a simple dollar peg. However its actual exchange rate policy exacerbated the copper price rise of the late 1980s and the decline of the late 1990s. Here a tighter peg to a major currency, especially the yen, would have done better. (The decline in the local copper price of 1995-98 could have been largely avoided.)

Mongolia lacks data for the 1970s and 80s. In the 1990s, we see that the copper price would have been relatively stable if Mongolia had pegged to a major currency. The monetary policy that it actually followed (classified as an independent float, but with a monetary aggregate target under an IMF-supported program as of 1999) led to a large increase in the nominal price of copper locally, and a large decrease in the real price (especially in 1996 and 1998).

The global aluminum market showed peaks in 1980, 1983, 1988 and 1995. Jamaica and Surinam are our two aluminum exporters. Both have experienced high inflation. Both follow managed floats. (Jamaica had a monetary target, as of 1999.) Jamaica by devaluing managed to raise the local price of copper sharply in 1994-95 and 1998-2000. But it suffered declines in the real price in 1989-93 and 1996-98 that must have hurt the competitiveness of this industry. The latter decline would have been less severe if Jamaica had been pegged to a major currency. Similarly, Suriname also achieved, through devaluations, very sharp increases in the local price of aluminum in 1994-95 and 1999-2000, but suffered steady declines during 1980-1993 and 1996-98 that would have been less severe if it had been pegged to a major currency.

The world price of platinum has been relatively less variable than some of the other mineral prices, but for a large increase in the late 1970s and a sharp fall in 1981. The big exporter is South Africa, though platinum is also a large share of the merchandise exports of St. Kitts and Nevis (which shares a currency with other members of the East Caribbean Common Market). Both countries succeeded with their actual exchange rate policies in stabilizing the local price of platinum somewhat, relative to what would have happened if they had pegged rigidly to a major currency.

### ***Wheat and coffee prices***

Let us turn from the minerals to consider two agricultural commodities. The world wheat market has experienced roughly four complete cycles since the early 1970s, featuring peaks in 1974, 1981, 1989, and 1996. The variability has been highest in terms of yen, less in terms of dollars, and the least in terms of marks. Three countries have

wheat exports that are more than 3 per cent of goods exports: Argentina (7%), Australia (4%), and Mozambique (3%). Argentina had a hyperinflation that was only vanquished at the end of the 1980s, definitively so in the convertibility plan of 1991. Mozambique had a similar bout of inflation. Turning to the statistics on the real price of wheat, we see that Argentina would have reduced real variability if it had pegged to the dollar (or mark) throughout, rather than only during 1991-2001. It would have not experienced very sharp peaks in 1975, 1982, and 1989, and the sharp drops that followed each. The steady decline in the dollar price of wheat that Argentina experienced during 1996-2000, on the other hand, would have been milder if it had been pegged to the yen or mark rather than the dollar. Australia achieved a more stable local real price of wheat with its flexible exchange rate than it would have experienced by pegging to a major currency (especially in the 1970s). Data availability for Mozambique limits us to the period since 1987. Movements in the exchange rate of the Mozambique currency exacerbated each of several swings in the local price of wheat during this period, relative to what would have prevailed if the country had pegged to a major currency. The local-currency decline of the late 1990s was particularly strong.

The world coffee market is especially volatile: a sharp rise in 1975-77 and sharp declines in 1978, 1987, and the late 1990s. The variance appears the greatest when the coffee price is expressed in terms of yen. But this statistic is dominated by the spike of 1977. In the last decade, the swings were greatest in terms of dollars (upward in 1993-97, and downward subsequently).

The list of countries specialized in coffee is long, and they rival the oil producers for concentration relative to exports or GDP. We focus on a set of thirteen: the five Central American countries, three in South America (Brazil, Colombia, and Peru) and five in Africa (Ethiopia, Tanzania, Kenya, Cameroon and Madagascar).<sup>22</sup> All have coffee exports that exceed 4 per cent of goods exports, or 3 percent of total goods and services exports. Ethiopia is the leader, at 57 % of goods exports, followed by four of the Central American countries at 18-25 % of goods exports.

Nicaragua is the conspicuous hyperinflater in the group (1980s), though Brazil also qualified. Even in real terms, and even if the anomalous year of 1973 is excluded, Nicaragua would have had a more stable local real price of coffee if it had pegged to one of the major currencies. Most of the others, however, would have experienced variability in the local real price of coffee if they had pegged that was greater than, or similar to, what they actually experienced. (Other exceptions are El Salvador and Peru.)<sup>23</sup>

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<sup>22</sup> Edwards (1984, 1986) explores the macroeconomic implications of the coffee cycle in Colombia. Devarajan and de Melo (1987) includes the case of a boom in coffee and cocoa in Cameroon in 1976-77. Cameroon is a member of the Central African Economic and Monetary Community.

<sup>23</sup> Costa Rica and Nicaragua have crawling pegs against the dollar, while Honduras has a crawling band. El Salvador has recently gone beyond a dollar peg, and adopted the dollar as legal tender. Guatemala has technically followed a managed float (but is considering full dollarization), and Peru is formally classified as independently floating (IFS, 1999). Brazil and Colombia float, after having abandoned intermediate regimes in 1999.

## Implications of Alternative Currency Pegs for Exports

We have seen what would have happened to the price of the principal export commodity under alternative pegs. But it would be desirable to go beyond that simple analysis. The relevant objective is not so simple as just minimizing variability in the real exchange rate. Rather, countries seek to maximize the long-run growth rate, avoid financial crashes, etc. If the goal were simply to minimize the variability in the price of gold or oil, then pegging the currency to the price of gold or oil would automatically be the right answer. While we wish to consider this regime, we don't want to pre-judge its merits. It might be desirable to have some variability in the real price of the export commodity, if the price increases came during periods when the country most needed boosts to export revenue, e.g., to service debt.

Suppose we are willing to make some crude assumptions about the behavior of exports and output, particularly with regard to price elasticities. Then we can simulate what the path of the economy's international sector might have looked like with alternative exchange rates and prices, e.g., what would have happened if the country had been pegged to the dollar or to gold throughout the period, as opposed to following whatever exchange rate path it actually followed. We can simulate paths for exports, the trade balance, debt, debt service requirements, and reserves.

Our crude assumption will be that (1) for every one percent real depreciation of the local currency against major world currencies and commodities, exports in terms of dollars (or other major currencies) would have risen by one percent in that same year, and (2) GDP in terms of dollars would have been unchanged. The assumption that exports would have risen proportionately could be interpreted as arising from two premises: that the price of the exportable good is determined in terms of foreign currency (which seems the appropriate model for small countries that produce mineral or agricultural products<sup>24</sup>), and that the local elasticity of supply is one. This assumption is conservative in that it omits any effect whereby local residents respond to an increase in price by consuming

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Ethiopia and Kenya are also classified as managed floaters, Tanzania and Madagascar as independently floating.

<sup>24</sup> If a substantial number of gold producers, representing a substantial fraction of global gold supply, were simultaneously to implement the proposal to peg their currencies to gold, then we would have to recognize that the gold price would become endogenous. Fluctuations in the world demand for gold would induce contrary responses in world supply, thereby exacerbating the global price fluctuations: When the world price of gold falls, gold-pegged producers would automatically depreciate, responding by raising production and thereby further dampening the world price. But the United States, Canada, and some other industrialized countries constitute a large share of world gold production, and the gold-pegging proposal is not intended to apply to them. Furthermore, changes in the annual flow of gold supply are relatively small as a fraction of the outstanding *stock* of gold in the world, and it is the latter that is the key supply-side variable. In any case, the results reported here (especially for perishable agricultural commodities where flow supply is an important determinant of price) are best understood as applying to regime decisions of an individual country.

less of the tradable good and thereby leaving more for export (which is not unrealistic in the case of exports like gold or coffee where local consumption is relatively small, but *is* unrealistic for many products). It would be fairly easy to relax these assumptions. The second assumption, that GDP would be unchanged in dollar terms, is roughly justified by the logic of two offsetting considerations: the stimulus to export competitiveness would likely raise GDP in local terms, while the change in the exchange rate means that each unit of local output would translate into fewer dollars. If devaluations have contractionary effects on demand, this assumption might understate the increase in the export/GDP ratio. On the other hand, if there is a large positive Keynesian multiplier from exports to GDP, then our calculation might overstate the increase in the export/GDP ratio.

Our primary interest is not in a comprehensive comparison of the path of exports that the economy would have followed if pegged to the dollar with the actual path of exports. To do so would leave out important considerations such as, on the one hand, the inflation-fighting benefits of pre-commitment to a dollar peg, and, on the other hand, the potentially stabilizing benefits of a discretionary monetary policy when the exchange rate is flexible. Our primary interest, rather, is in comparing the dollar path with the path under a peg to gold or other candidates. We calculate, if the country had pegged to the yen instead of the dollar, what would have been the local currency price of commodities, and what would the effect have been on exports (again with crude assumptions about elasticities). We do the same with a peg to the euro, represented during our historical period by the German mark. (Eventually we hope to repeat the experiment with a basket of the three currencies.) Then we see what would have happened to the exports of the gold-producing country if the value of the domestic currency had been fixed in terms of gold, rather than in terms of a major currency. And so on with the other commodities.<sup>25</sup>

### ***Gold exports***

Burkina Faso's history shows a strong upward trend in exports from barely 6 percent of GDP in 1970 to more than twice that at times in the 1990s. Our discussion of prices already noted that Burkina Faso, with other CFA countries, underwent a real devaluation in 1994, which helped correct an overvaluation of the preceding decade (which in turn could be attributed to an appreciation of the French franc against the dollar after 1985, and to an inability under the CFA constraints to devalue against European currencies in the way that English-speaking African countries had). This real depreciation presumably contributed to the subsequent (small) increase in exports, peaking in 1997. More importantly, if Burkina Faso had been constrained from devaluing, as under a rigid peg to the mark/euro, then according to the simulation, the level of exports would have fallen sharply in 1994-97, to low levels not seen since the early 1970s. A rigid peg to the yen would have had the same effect. A dollar peg would have prevented the initial overvaluation from opening up, as the dollar depreciation of 1986-1993 would have boosted exports, but that favorable effect would have been entirely reversed during the period of dollar appreciation, 1995-1999. Thus, overall, the

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<sup>25</sup> These and other results are available in detail at <http://people.brandeis.edu/~smap/counter/> or at [http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank\\_price.html](http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank_price.html).

actual path followed by Burkino Faso in the 1980s and 1990s looks better than the hypothetical path of pegging to a major currency.

A peg to gold looks better for Burkino Faso -- the former Upper Volta -- than a peg to any of the major currencies. It would have boosted exports over the period 1983 to 1993, by automatically depreciating the currency. There would have been a sharp reversal of this gain in 1994, because the necessary devaluation would have been prevented, the same as under any of the major currency pegs. There also would have been a recovery in the late 1990s. Overall, exports would have exhibited a better upward trend under a gold peg than under any of the alternative pegs to a major currency.

By the start of the 1980s, a gradual downward trend in Ghana's exports had left them at just a few percentage points of GDP (perhaps due in part to an overvalued currency). Over the subsequent decades, this adverse trend was reversed. The simulations in the Figure show that if Ghana had pegged its currency to an external anchor, its exports would not have reached such a low level in the early 1980s, but would have been considerably more variable overall. Specifically, there would have been a sharp increase in exports that reached a high peak in 1982-83. This result holds even under the hypothesis of a gold peg, but holds more strongly for pegs to the major currencies, all of which depreciated against gold throughout the 1970s. The resulting increase in the early 1980s, and the subsequent reversal, would have been especially large if the peg had been to the yen. The upward trend in exports that Ghana actually experienced in the 1990s would have occurred as well under any of the alternative regimes. But it would not have been as strong if the country had been pegged to one of the major currencies. Only under the gold peg would the upward trend have been comparable in magnitude to what Ghana actually experienced.

Papua New Guinea's exports were relatively stable in the 1970s and 1980s and moved upward in the 1990s, above 50 per cent of GDP in some years. A peg to the dollar would not have been very different. A peg to the yen would have prevented the upward trend of exports from 1985 to 1994. A peg to gold would have induced steep drops in exports in the 1970s (when the gold price was soaring), but would have accentuated the upward trend subsequently.

South Africa's exports over the last three decades have fluctuated in the range of roughly 22 to 35 percent of GDP. The graph shows that South Africa's exports increased in the 1970s and declined in the early 1980s, mirroring the world gold price, and then returned to a gentle upward trend in the 1990s. A peg to the dollar would have engendered an upward trend in exports in the 1970s (while the dollar was depreciating), but a downward trend subsequently. A peg to the yen would have resulted in a downward trend throughout most of the period. A peg to gold would have had very different implications in the 1970s than subsequently. When the world price of gold rose sharply in the 1970s, if the South African rand had risen with it, then the loss of competitiveness would have dampened the rise in exports. This may not sound like an advantage, but the subsequent decades tested out the reverse proposition. Indeed, as the world price of gold followed a long downward trend in the 1980s and 1990s, a gold-pegged South Africa would have gradually gained competitiveness. The interesting

thing is that this is true not only relative to the dollar peg, but also relative to the policy actually followed by South Africa. In other words, whatever flexibility has existed in the rand in recent years has not in practice been used to offset terms of trade shocks in the way that floating rates should in theory do automatically. At least, flexibility has not accomplished this purpose so well as a rigid gold peg would have done. Political reluctance to devalue may explain this result for South Africa, and for some other countries' experiences as well.

Similar patterns hold for Bolivia, Fiji, Guyana, Mali, Mongolia, and the other gold-producers on our list, although for some countries some of the necessary data are lacking for the first part of the period. In general, a peg to gold would have engendered losses of competitiveness and therefore declines in exports in the 1970s, but gains in competitiveness and gains in exports in the 1980s and 1990s. A peg to the dollar would have spurred competitiveness in the 1970s, but hindered it in the early 1980s and late 1990s. A peg to the yen would have contributed to a gradual loss of competitiveness during most of the period, until 1995. The story for the mark (and probably for other continental European currencies) would have been broadly similar to the yen, though less extreme.

### *Oil exports*

We turn next to oil producers. As already noted, rigid pegs to any external anchor would have eliminated the competitiveness gains that come from devaluation, such as the boosts to exports that were in fact experienced by Ecuador in 1999, Indonesia in 1998, Mexico in 1995, Nigeria in 1999 or Russia in 1998-99.

In the 1970s, many of the oil producers, such as Colombia, Ecuador, Indonesia, and Nigeria, would have experienced even bigger export booms than they did if they had been pegged to the dollar. A dollar peg would also have boosted the height of a plateau in Nigerian exports in 1996. A dollar peg for Mexico would have produced a long upward trend that was smoother, but otherwise similar in magnitude to other pegs.

There are periodic proposals that Southeast Asian countries ought to give more weight to the yen than they have in the past. A yen peg for Indonesia would have resulted in the same export booms in 1974 and 1980, but would have given a smoother path during the period after oil prices stabilized at a lower levels in 1986. In the critical year 1998, the simulation results for any of the pegs eliminate the sharp upward spike in the ratio of exports to GDP that Indonesia's currency collapse in fact produced. But some would argue that if a very firm peg had been in place, that crisis might not have occurred at all. Thus the more relevant comparison is between the dollar peg and the yen peg. A yen peg would have produced some gain in competitiveness between 1995 and 1998, but the boost to exports looks small compared to the very big reduction in the early 1980s.

Of our seven oil exporters, Russia is the only serious candidate for pegging to the DM or euro. The simulation shows that a firm peg to any of the three major currencies would have turned the 1994-1997 decrease in Russia's exports/GDP into a gain, presumably because it would have reduced Russian inflation. But, again, the interesting

comparison is across pegs. A peg to the DM would not have produced the same 1998 peak in exports or subsequent reversal that a hypothetical yen peg would have produced. But if Russia had been tied to the euro in 1999-2000, it would have shared in that currency's depreciation and thus increased exports.

A peg to the price of oil would have had a negative effect on all oil exporters in the 1970s. Exports in Venezuela, for example, would have reached lows by 1979 that were more extreme than any other regime or year. But an oil peg would have had mostly positive effects on exports thereafter (exceptions are the years 1986 and 2000). In the critical year 1998, an oil peg would have boosted Colombia's exports to almost 30 percent of GDP, Ecuador's and Venezuela's over 40 percent, Mexico's and Russia's over 50 percent (even without discrete devaluations), and Nigeria's over 100 percent. These are striking results, as all these countries were severely affected by international financial turmoil that year, and were desperate for higher foreign exchange earnings. Among the grains of salt with which the findings must be taken is the caveat that those countries that are members of OPEC (Ecuador, Indonesia, Venezuela and Nigeria), probably could not have taken full advantage of the simulated depreciation without violating their OPEC oil quotas. On the other hand, OPEC's real power over this set of countries is questionable. Furthermore, when such countries are hurt by international conditions, including low world oil prices, additional dollars earned through boosts to their non-oil exports (included in these export simulations) are at least as useful as dollars earned through oil exports.

### *Exports of other minerals*

Our two silver producers, Bolivia and Peru, experienced no particular overall trends in their exports over the period 1985-2000. Bolivia experienced an export contraction in 1999-2000, however. The simulations indicate that a firm dollar peg would not have altered this picture much. A yen peg would have added some waves in both countries, including a positive effect on exports over 1995-98 but the reverse in 1999. A peg to the price of silver would have added some more waves: an upswing from 1988-91 and downswings in 1992-94 and 1997-99.

Chile, our leading copper exporter, experienced an upward trend in exports as a share of GDP, presumably related to a free-trade policy. The simulation indicates that the sharp rise of 1973-74 would have instead been a sharp fall if Chile had been rigidly pegged to any of the three major currencies, presumably because it would have lost the ability to devalue, and it would also have missed out on a rise in the late 1980s. If the Chilean peso had been fixed to the price of copper, it would have experienced a strong upward increase in exports during the period 1994-1999, which would have been very useful given the pressures on emerging markets at that time.

Of our two aluminum producers, Jamaica has over the three decades achieved more increases than decreases in exports, and Suriname the reverse. But both countries suffered a decline in their export ratios in 1993, for example, and a fall in the real price of aluminum may be part of the reason. These countries were sufficiently closely tied to

the dollar over the period 1970-1983 that a rigid dollar peg would have made little difference. But subsequently, it would have given a smoother export path to Jamaica. The catastrophic trough in exports that Suriname had hit by 1993 would have been postponed by one year if the country had been pegged to a major currency; but the low simulated export levels during 1994-1998 – a consequence of the inability to devalue -- would have been poorly timed, in light of financial pressures in emerging markets.

Our two platinum producers are South Africa and St.Kitts and Nevis. A peg to the price of platinum would have imposed substantial export troughs in 1979, 1988, 1994, and 1999, but substantial boosts in 1992 and 1998.

### *Exports of two agricultural products*

We now return to our three wheat-producers. Argentina's ratio of exports to GDP has long and famously been low. It has had a gradual upward trend, but with occasional severe downturns, particularly in 1975, 1980, and 1992. The high inflation rates, including hyperinflations, in the 1970s and 1980s make it difficult during that period to compare actual exports to what would have prevailed under a peg. A monetary stabilization was accomplished in 1990, and was locked in in 1991. Exports fell sharply from 1989 to 1992, as the real appreciation of the peso (initially attributable to residual inflation) left it overvalued in real terms, and then gradually recovered from 1993 to 1997, before suffering anew when its trading partner Brazil devalued in January 1999. According to the graph, exports would have experienced a strong upward trend over 1989-2000 under each of the alternative pegs. The reader might wonder why the result for the dollar peg in the 1990s differs from the actual path followed by Argentina, since the convertibility plan was precisely a tight peg to the dollar. The answer is that all our simulation results hypothesize that the local inflation rate (in this case Argentina's) converges instantaneously and fully to the inflation rate of the country of the anchor currency, in this case the United States. The experiment is thus designed to capture a fully credible and complete monetary integration. This was not exactly Argentina's experience. A currency board, while it is a meaningful political commitment, falls far short of a fully credible currency peg, as the interest rate premiums paid by Argentina in the 1990s and the occurrence in December 2001 of the long-feared collapse of the peso illustrate. Furthermore, the problem was not lack of sincerity or determination on the part of the implementers of Argentina's currency board. Nevertheless, price levels did not in fact converge.<sup>26</sup> Thus the immediate gain in exports that the graph shows for the dollar peg during 1989-1990 probably should not be interpreted as an alternative that was available to Argentina in the short run.

The comparison of results *among* the four candidate pegs over the decade is genuinely illustrative of what might have happened if our agricultural producers had chosen alternative regimes. Upswings in exports resulting from a dollar peg would have

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<sup>26</sup> Hong Kong's experience with its currency board indicate that having an open, flexible and debt-free economy is not enough to achieve full convergence of inflation rates, and Ecuador's experience with dollarization indicate that abandoning one's currency altogether is also not enough.

been larger under a yen peg (in particular, during 1995-98). But they would have been followed by downturns (particularly in 1989 and 1995). In the Fall of 1998, the temporary reversal of a period of yen depreciation would presumably have been difficult for a yen-pegged Argentina, as it headed into what was to prove to be its period of maximum stress. A tie to the mark, or its successor the euro, would presumably have looked better during this critical period. But the graph indicates that a peg to the price of wheat would have performed the best. It would have provided the maximum increase in exports over the decade, including the critical years beginning in 1999. This is of course a consequence of the fact that world agricultural prices were depressed in the latter part of the 1990s, especially in terms of dollars. It is perhaps not a coincidence that this was a period of crisis for Argentina, as agricultural products together make up a substantial share of its exports. This simulation seems to make a strong case for pegging to the price of the export commodity.

Australia is an interesting case, because it is a major exporter of agricultural and mineral products, and follows a floating exchange rate that is often justified as a useful mechanism for accommodating terms of trade shocks. For example, it has been claimed that Australia was spared the worst of the East Asian crisis because its currency automatically depreciated along with world market conditions for its exports, and it has even been proposed that countries like Argentina should use the Australian dollar as an anchor because it is a proxy for commodity prices.<sup>27</sup> The Figure suggests that Australia's path over the last three decades would not have been so very different if it had been rigidly pegged to the dollar. (The largest differences would have been gains of competitiveness in 1974 and a loss in 1985.) A yen peg would have imposed a long downward trend. A mark peg would have sharpened the 1984 and 1997 gains in competitiveness. If the Australian dollar had been pegged to the price of wheat, its exports would have been considerably more volatile, but with an upward trend, featuring unusually sharp increases in exports in 1987, 1991, 1994 and 1997. The Australian dollar may in fact be a very imperfect proxy for the price of wheat or other commodities.

The Mozambique economy has made tremendous progress since the end of its wars, though we lack the data to make a complete comparison with the 1970s and 1980s. Unfortunately, it suffered from a decline in exports in the second half of the 1990s, which it would have avoided if it had been pegged to the yen or mark. If Mozambique's currency had been pegged to the price of wheat, the swings its exports would have been more exaggerated than under the alternative currency pegs. But like the other wheat exporters, it would have benefited during the difficult period of international currency and financial crises that began in 1997.

We conclude with our coffee producers. The sharp rise in world coffee prices in 1975-77 showed up as increases in exports in the case of the Central American countries; for the others coffee was probably not a large enough share of their exports. The sharp

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<sup>27</sup> David Hale has often pushed this viewpoint. E.g., Hale, "The Fall of a Star Pupil," *Financial Times*, January 7, 2002; or "Will Argentina's Crisis Destroy the Washington Consensus?" *Zurich Financial Services*, January 22, 2002.

price decline in 1987 seems to show up as a fall in exports in some countries (e.g., Colombia and El Salvador).

A currency peg would have prevented Brazil boosting exports via devaluation in 1999 and Colombia in 1999 (or Costa Rica in 1981, Guatemala in 1986, and Madagascar in 1987). But a peg to coffee would have induced large swings in every one of the coffee-exporters: export crashes in 1977 and 1994, and particularly sharp export rises in 1992 and the period 1997-2000. While the lesson may be that coffee prices are too volatile to make a suitable peg, the stimulus afforded by pegging to a depreciating coffee standard in the late 1990s would have been very well-timed.

### ***Overview of simulated effects on exports in the late 1990s***

The array of countries, commodities and currencies studied here is too diverse to allow a succinct summary of the export results. But it may be instructive to look at a cross-section of experiences in the late 1990s, a time of global financial pressures. Whatever the degree of exchange rate flexibility with which our countries entered this period, most gave more weight to the dollar than to other possible anchors. As a result, the appreciation of the dollar in the late 1990s added to their difficulties. During this period, a link to the DM/euro or yen would have done better. But that is largely coincidence. More interesting is what would have happened if they had pegged to the price of their leading mineral or agricultural export commodity. Because the prices of aluminum, coffee, copper, gold, oil, and wheat were depressed in the late 1990s, a peg to these commodity prices would have enhanced competitiveness. If the countries that were specialized in the production of these commodities had pegged their currencies to those prices, they would have boosted their exports at just the right time. This result is not entirely coincidence, in that weak commodity prices, especially in terms of dollars, were an important component of the wave of crises in emerging markets, as it had been in the international debt crisis of 1982.

### **Indicators of Financial Health**

A higher level or lower variability of exports is not the ultimate objective of economic policy. We need a way of evaluating whether the overall effect of various pegs on a given country would have been favorable or unfavorable. How should we gauge the financial or economic health of a country? According to economic theory, what ultimately matters is the country's standard of living, averaged over time. Technically, what matters is an intertemporal average such as the present discounted value of income or consumption. Swings in countries' export revenues can be smoothed over time -- by borrowing when market conditions are bad and paying back when markets are good. In this view, variability in a country's income need not be damaging.<sup>28</sup>

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<sup>28</sup> The argument for using income as the measure would be that the consumption data are less reliable. The argument for using consumption is the practical difficulty of knowing how to discount expected future income, and the argument that in theory intertemporally optimizing households have already done the discounting when determining their current consumption.

In reality, it is clear that this sort of theoretical approach in any case will not work. Financial markets do not in fact smooth consumption over time in the way the theory says. If they did, international capital flows would not be as procyclical as they are, periodic currency crises would not be as severe as they are, and the entire exercise of trying to reduce volatility by choice of monetary regime would be of less interest. It is more accurate to say that there is a flow of capital to Nigeria, Chile, Argentina, and South Africa when the world markets for – respectively -- oil, copper, agriculture, and gold are strong, than when they are weak. It is precisely when poor countries' export markets are weak that the world's investors pull out their money and when financial crisis is most likely. In other words, financial markets do not carry out their assigned smoothing function very well. It does not matter for our purposes what is the market failure, that is, the source of the deviation from textbook theory. The root of the problem could be imperfect domestic institutions (e.g., governments that can't resist launching grandiose spending projects when the export revenue is available, and bailing out banks and other domestic cronies when times are bad) or it could be fickle international investors (who participate in speculative bubbles and attacks, as in recent theories of multiple equilibria). All that matters is that these boom and bust financial cycles do in fact occur.

The exercise to be undertaken is to consider the case of a country that has already decided to adopt a long-term nominal anchor, and to consider the choice of alternative nominal anchors from the standpoint of reducing the amplitude of the boom-bust cycle that produces periodic crises in emerging markets. The measures of financial health that we wish to emphasize are those that have been used in the burgeoning research on "early warning" indicators, developed in response to recent crises.

### **What would have happened to the financial indicators under alternative pegs?**

For the time being, we will maintain our assumption that price elasticities are unity (contemporaneously). In the case of the export commodities, we are thinking of these as supply elasticities, since we are thinking of our countries as price-takers on world markets. We are also assuming that the entire production is exported, an assumption that is probably not too far off for gold, oil or coffee, but is admittedly unrealistic for wheat or rice. Under these (extremely restrictive) assumptions, commodity exports would have been one percent higher for every one percent increase in the price of the commodity in terms of local currency.

We have already found that if the Argentine peso had been pegged to the euro in 1999-2001 instead of the dollar, that the peso price received for wheat exports would have been higher at precisely the time when it was needed; and that if the peso had been pegged to the price of wheat, the benefits would have been even greater. But we want to see if this logic holds up in the simulation of financial indicators. Theory cannot give us the answer because the outcome depends on the nature of the shocks. If the most important shocks are those that occur in the world market for the export commodity, then a regime that leads to real depreciation at those times when the world market is depressed should indeed be a regime that stabilizes export revenue. But if the most important

shocks are idiosyncratic domestic shifts, such as bad harvests or monetary expansions, then there may be no systematic implication of the regime for volatility.

Here we assume that imports and transfers are exogenous.<sup>29</sup> We compute the counterfactual for the trade balance based on our calculations for the impact on exports. We have allowed for the endogeneity of total international interest payments, in proportion to the simulated difference in net international debt. A different trade balance in the first period implies a different change in the net international investment position or net debt position that is carried into the subsequent period. In each subsequent period, the simulated change in the current account balance then translates into net debt.

### *Current accounts and Debt/export ratios*

We have simulated alternative paths for the current account and the debt/export ratio.<sup>30</sup> These simulations assume, not only that exports respond to real exchange rates with an elasticity of one, but also that imports and transfers do not respond at all. Thus the export revenue response is assumed to translate directly into the trade balance. In the first period the effect on the trade balance is also assumed to translate directly into the current account. The current account each year, in turn, is assumed to be the change in the debt stock. But in the second and subsequent periods, the higher or lower debt stock is assumed to imply proportionately higher or lower interest payments, which are added into the current account, i.e., the change in next period's international investment position. These assumptions could of course be made more elaborate.

Here are some highlights from the results. Burkino Faso could have avoided the debt/export jump it experienced in 1992 by adopting any of the alternative regimes. It would have experienced a particularly strong improvement in its current account that year if the country had been pegged to gold. The weak spot for the gold peg would have been the 1980s, because the gold exporter would have run large current account deficits over the preceding decade. The weak spot for the mark/euro peg would have been the late 1990s. By the end of the sample period, in 1999, the debt/export ratio under the gold peg would have fallen, not just below the debt/export ratio under the euro peg, but as well under the yen peg, dollar peg, and actual historical path.

Many of the other most important gold producing cases also show by 1999 a relatively low debt/export ratio under the gold peg: Bolivia, Mali, Papua New Guinea, Peru and South Africa. During the course of the 1990s, Peru and South Africa would

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<sup>29</sup> One approach would be to apply the unit elasticity assumption also to imports, and assume that imports of a world basket of goods would have been one percent lower for every one percent depreciation of the currency in trade-weighted terms. Another approach would be to focus on the supply of tradable goods, taking the export calculations that we have already performed as a lower bound on the importance of tradable goods in the economy and taking 100% of GDP as an upper bound.

<sup>30</sup> Simulations for Debt/Export ratios are available as Table Set V at [http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank\\_price.html](http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank_price.html). Simulated current accounts with endogenous interest payments are at [http://people.brandeis.edu/~smap/COUNTER/CA/CF\\_CA\\_calcnote.txt](http://people.brandeis.edu/~smap/COUNTER/CA/CF_CA_calcnote.txt).

have experienced improvements in their current accounts rather than worsenings. Of the various regimes, only the gold peg would have saved Bolivia from a collapse in its current account in the late 1990s.

If Colombia had been pegged to oil, its debt/export ratio would have been much higher throughout the 1980s (though Colombia did not in fact suffer the debt problems of other Latin American countries at this time, and the results seem to suggest that an oil peg could have been the one policy to rescue Colombia from its troubles in 1998-99). Other oil exporters -- such as Ecuador, Mexico, Nigeria and Venezuela -- would have suffered such an appreciation by 1980, if their currencies had followed the price of oil upward, that their debt levels in the subsequent decade would have been disastrously high.

If Chile had been pegged to copper, its debt/export ratio would have looked better than it actually did during the two critical periods of the early 1980s and the late 1990s. Chile would have had much lower debt/export ratios in the 1970s and early 1980s by pegging to any of the major currencies. If Cameroon had pegged to coffee, it would have experienced severe peaks in its debt/export ratio in 1977 and 1986, but would have done so well in the 1990s as to become a substantial net creditor, according to our simulation. Similar patterns hold for Colombia, Kenya, and the Central American countries. A peg to coffee would have allowed Ethiopia to avoid altogether the sharp 1992 run-up in its debt/export ratio. The simulation results for Argentina show the creation of a sharp spike in 1989 under a wheat peg, or for that matter under any peg, but this must be an artifact of the hyperinflation that infects that country's data in the 1980s peg. It is followed by a decline to moderate levels in the late 1990s.

### *Plans for extensions*

A future extension could simulate the level of reserves, since this variable appears as an important crisis indicator in the three generations of theoretical models of speculative attacks as well as in the empirical studies of early warning indicators. In order to pursue the period-by-period simulations, we will treat private capital flows as exogenous, and assume that effects on the trade balance show up in central banks' reserve holdings. Needless to say, capital flows would certainly have been different if radically different policies had been followed. But the spirit of our exercise is that the leading cause of sudden large declines in the net inflow of capital is loss of confidence due to the fears and realities of financial crises.<sup>31</sup> Our argument is that if alternative pegging policies would have moved the crisis indicators in favorable directions at the times when they were historically most in difficulty, then the pattern of capital flows would probably have been better. In that case we can draw our tentative conclusions about whether the overall effect would have been favorable or unfavorable, without having to model capital flows explicitly.

We hope ultimately to compute a weighted average of financial indicator variables, such as debt service ratios and reserve/import ratios. The weights on the various indicators could come from a number of places. The simplest is a uniform

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<sup>31</sup> Calvo and Reinhart (1999) call these episodes "sudden stops."

weighting scheme. More precisely, each indicator is weighted by the inverse of its sample standard deviation.

The alternative is to use as weights the coefficients that have actually been estimated in the early warning research, generally to predict the probability of currency crisis. One possible source of coefficient estimates comes from Frankel and Rose (1996).<sup>32</sup> More recent studies of early warning indicators include Kaminsky, Lizondo and Reinhart (1999), Berg, Borensztein, Milesi-Ferreti, and Patillo (1999), Edison (2000), Goldstein, Kaminsky and Reinhart (2000), and Wynn, Nowell and Blackman (2000).

For each of our sample developing countries, we could trace the simulated path of the financial health indicator, whether univariate or weighted-average. We could take note of whatever correspondence there is between the high-points of the indicator for each country and its known crises or difficult periods.

We could then ask the counter-factual question: how different might the indicator variables have been if, instead of whatever exchange rate policy the country actually followed, it had pegged to the dollar, the euro, gold, or a number of possible other alternatives. As in what we have done so far, the exercise necessarily involves making some arbitrary assumptions regarding how exports and other variables would have responded if the exchange rates and commodity prices had been different. We hope to be able to consider more elaborate and realistic assumptions in the future.

## Conclusion

The currency regime proposed in this study is not for everybody. But for small countries where gold makes up a large share of national production and exports, a novel strategy of pegging the currency to the price of gold might make sense. Of course this commitment would mean giving up the benefits of discretionary monetary policy. But some small developing countries have found those benefits to be elusive at best, and so have either already given up monetary independence anyway or are considering doing so. For such a country, a peg to gold may give the best advantages of both worlds: the enhanced credibility that the gold standard is traditionally supposed to deliver, combined with the automatic adjustment to terms of trade shocks that floating rates are in theory supposed to deliver. Similar arguments can be made for countries that are specialized in the production of other commodities.

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<sup>32</sup> We could consider two sets of weights: from univariate estimation in Frankel-Rose (1995) and multivariate estimation in Frankel-Rose (1996). The latter are theoretically of greater interest, since they were estimated in a statistical exercise to choose the best overall predictor of currency crashes. But we would omit some of the variables that were included in the multivariate estimation, so that those coefficients lose the interpretation as optimal prediction regardless. (We would omit short-term debt, for example. Although this is a good near-range predictor of crisis, it may not be a fundamental source of trouble, so much as an early-warning symptom.). On the one hand, there is a certain attraction to focusing on the univariate estimates, as they can potentially correspond to conventional rules of thumb used by international investors. On the other hand, to focus on the history of a dozen indicators, one by one, for each of several dozen countries, would produce more information than one can cheerfully absorb.

Our simulation results illustrate how such a peg, if it had been applied in the past, would at times have been superior to conventional pegs to the dollar or to other major currencies. In particular, many commodity exporters in the late 1990s were hit by three simultaneous shocks: scarce international finance, a strong dollar, and weak commodity prices. If they had been pegged to their principal export commodity at this time, rather than to the dollar, they would have gained export competitiveness at precisely the time when their balance of payments was under maximal strain. Such countries as Bolivia, Ghana, Mali, Papua New Guinea and Peru would by 1999 have achieved stronger debt/export positions if they had been pegged to gold. The commodity peg will not always work in such a beneficial way as this. But this study suggests that the idea is at least deserving of future exploration and consideration.

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On [http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank\\_price.html](http://ksghome.harvard.edu/~jfrankel.academic.ksg/counterfactual/rank_price.html) can be found sets of tables and figures I though V, including technical appendices.

Guide to files: <http://www.brandeis.edu/~smap/files>

Listing of files (including Figure Set VI) at:  
<http://people.brandeis.edu/~smap/counter>

#### Table Set I.

Statistics on countries specialized in the production and export of gold or other mineral or agricultural products (with detailed explanation in appendices) --

Click on: [http://people.brandeis.edu/~smap/rank\\_price.html](http://people.brandeis.edu/~smap/rank_price.html)

Mnemonic in file names: rank

#### Figure Set II.

Actual and calculated paths of price of the export commodity under alternative hypothetical currency peg assumptions

Click on: [http://people.brandeis.edu/~smap/rank\\_price.html](http://people.brandeis.edu/~smap/rank_price.html)

Mnemonic in file names: graph

#### Table Set III.

Statistics on variability of commodity price under alternative currency peg assumptions

Mnemonic in file names: stat

Click on: [http://people.brandeis.edu/~smap/rank\\_price.html](http://people.brandeis.edu/~smap/rank_price.html)

#### Figure Set IV.

Simulated path of Export/GDP under alternative peg assumptions.

Mnemonic in file names: XG

Click on:

<http://people.brandeis.edu/~smap/counter/counter.html>

#### Figure Set V.

Simulated path of Debt/Export under alternative peg assumptions.

Click on:

<http://people.brandeis.edu/~smap/counter/counter2.html>

Simulated path of Current Account under alternative peg assumptions.

Click on:

[http://people.brandeis.edu/~smap/COUNTER/CA/CF\\_CA\\_calcnote.txt](http://people.brandeis.edu/~smap/COUNTER/CA/CF_CA_calcnote.txt)