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Managed floating as a strategy to achieve selected monetary policy objectives

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Abstract

The paper considers the connection between exchange rate regimes and economic performance as measured by inflation, output growth, and their volatility. It is argued first that the choice of an intermediate exchange rate regime is complicated by potential conflicts with the requirements of central bank transparency and accountability. These are considered to be longer run questions. Next, three types of managed floating regimes are defined. A variety of counterfactual experiments are shown to illustrate that a managed float, such that the objective of monetary policy is expressed in terms of an inflation target, will produce the most desirable macroeconomic outcome. The counterfactuals are supplemented with estimates of forward-looking Taylor rules to ascertain whether such rules are informative under a managed floating scenario. In general, the answer is that central bank reaction functions become less useful when the exchange rate regime is an intermediate one.

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1. Introduction

Skepticism about the usefulness of de jure exchange rate classification schemes of the kind reported by the International Monetary Fund (i.e., as in its once regular publication *Exchange Arrangements and Exchange Restrictions*) has spawned a burgeoning literature that proposes de facto exchange rate regime classifications (e.g., see Fischer, 2001; Levy-Yeyayti & Sturzenegger, 2001). For example, Fischer (2001) concludes that there is an apparent tendency toward "corner"

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solutions in exchange rate regime choices with a distinct preference in recent years for floating over the fixed variety of exchange rate regime (also see Bubula & Ötker, 2002). The bi-polar view is not, however, without its critics. Some have pointed to a "fear" of floating wherein countries that notionally prefer to float nevertheless intervene regularly to prevent full flexibility of the exchange rate (e.g., Calvo & Reinhart, 2002). Others have pointed out that some countries display an aversion to truly fixing their exchange rate, preferring instead to allow for the contingency that the existing peg may be altered if it becomes too costly to defend or macroeconomic conditions require a realignment of some kind (Willett, 2003). Therefore, there is skepticism that the two corners solution is the preferred explanation for the apparent evolution of exchange rate regimes over the past 2 or 3 decades (also see Angkinand, Chiu, & Willett, 2005). Instead, intermediate regimes of the managed floating variety seem to be fairly prevalent around the globe. More recently, some of these intermediate regimes have been designed as vehicles to constrain countries to follow monetary policies that would deliver low and stable inflation rates. Yet, such exchange rate regimes are not well understood nor are they widely studied.

A common theme in this literature is the assumption that managed floating is principally about attempts to manipulate exchange rate levels. Yet, many countries that the IMF used to classify as operating under an "independently floating" regime have in fact from time to time intervened not to achieve a particular target level for the exchange rate but to manipulate the size of exchange rate changes, or the uncertainty around exchange rate movements. One problem is that a standard definition of what is meant by the term "managed floating" appears to be missing. Does any form of central bank intervention in foreign exchange markets constitute a form of managed floating? Does managed floating refer only to setting a target level for the exchange rate, perhaps within some band to limit exchange rate volatility? What about the uncertainty surrounding exchange rate movements? More generally, does it matter whether the central bank or the government is responsible for exchange rate policy? The latter consideration raises questions about where accountability lies for decisions about whether and, under what conditions, foreign exchange intervention takes place, as well as the maintenance of the durability of the exchange rate regime itself. Moreover, managed floating of any kind raise issues about the degree to which the central bank, in particular, can be transparent about foreign exchange operations. Thus, for example, whereas countries that are ostensibly floaters have, sooner or later, made public intervention and other data about their foreign exchange operations (e.g., US, Germany, Japan), others (e.g., Asian economies) have been rather opaque about their exchange rate objectives.

While all the foregoing questions cannot be dealt with in one paper, the bottom line is that countries first have to decide for themselves how much they value monetary and fiscal independence. Here too, matters are more complicated for even if policy autonomy is considered highly desirable, choosing a floating regime may not be suitable if, for example, a country has not historically demonstrated a capacity to implement sound economic policies.

The paper examines the macroeconomic implications of choosing exchange rate regimes of the managed floating variety in both the long and short-run. First, it is argued that a successful exchange rate regime must be dependent on institutional considerations, in particular the twin characteristics of central bank accountability and transparency. Nevertheless, the impact of institutional factors may only be felt in the long-run. In the short-run, policy makers are more concerned about the effects of a particular exchange rate regime on inflation and output growth. While comparative studies of economic performance for a group of countries that have adopted different exchange rate regimes are useful, there are sufficient doubts surrounding exchange rate classification schemes to recommend a different approach to studying some of the relevant issues.

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