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What determines the extent of real exchange rate misalignment in developing countries?



Ridha Nouira^a, Khalid Sekkat^{b,c,*}

^a UREP, University of Sfax, Tunisia

^b Centre Emile Bernheim, University of Brussels, CP 114/03, 50 Avenue F.D. Roosevelt, 1050 Brussels, Belgium

^c ERF, Belgium

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ABSTRACT

The paper seeks to explain the extent of real exchange rate misalignment, defined as its deviation from its equilibrium level. It enlarges the traditional analysis, which focuses mainly on the role of nominal exchange rate regimes, to consider the role of the quality of institutions and financial development. The results show that the intermediate regime induces higher and more volatile misalignment than both fixed and float. The fixed regime exhibits a pattern of misalignment similar to the float regime. Inflation pressures and dependence on oil exports are associated with more misalignment. More importantly, persistence in misalignment is an important phenomenon that should be taken into account, better quality of institutions is associated with less misalignment, while financial development seems to have no impact on misalignment.

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1. Introduction

The misalignment of real exchange rate (RER) is an important concern of both academics and policy makers. Misalignment is defined as the departure of the RER from its equilibrium level for a relatively long

* Corresponding author at: Centre Emile Bernheim, University of Brussels, CP 114/03, 50 Avenue F.D. Roosevelt, 1050 Brussels, Belgium. Tel.: +32 2 650 41 39; fax: +32 2 650 39 01.

E-mail address: ksekkat@ulb.ac.be (K. Sekkat).

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time in contrast to volatility, which is defined as highly frequent but non-persistent fluctuations of the RER. Most empirical researches provide little support to the impact of volatility but have found a significant impact of misalignment on a variety of economic variables.¹ These include growth (Cottani et al., 1990; Ghura and Grennes, 1993; Rodrik, 2008; Harms and Kretschmann, 2009), capital accumulation (Goldberg, 1993; Servén, 2003; Kandilov and Leblebicioğlu, 2011), Foreign Direct Investment (Froot and Stein, 1991; Goldberg, 2009), exports and diversification of export (Sekkat and Varoudakis, 2000; Freund and Pierola, 2012), currency crisis (Bussi ere and Fratzscher, 2006) and trade balance (Hoffmann, 2007).

RER misalignment is traditionally associated with the choice of an exchange rate regime; especially after the breakdown of the Bretton-Woods system in 1973. In principle, each country declares its choice to the IMF. This is called *de jure* regime. However, in practice *de jure* and the actually implemented regimes rarely coincide. This discrepancy led to the development of the concept of *de facto* regimes (Reinhart and Rogoff, 2004; Levy-Yeyati and Sturzenegger, 2005), which refer to the exchange rate regime actually implemented. In this paper we focus on the *de facto* concept.

Broadly speaking, each country can *de facto* peg its exchange rate to another currency, letting it float freely or control its float. Each category includes some variants. The regimes refer to the level of the nominal exchange rate level and the association with the misalignment of such a level can be easily understood. However, the association with the RER (defined as the ratio of domestic to foreign prices expressed in a common currency) misalignment is less straightforward. According to standard macroeconomic models, it is not a priori clear which of the regimes induces more misalignment. Under a flexible regime the exchange market determines the appropriate level of the nominal exchange rate. Hence, the RER misalignment is, at worst, only temporary. In contrast, the fact that under fixed regimes nominal exchange rates cannot be adjusted² induces the risk of pervasive RER misalignment. However, if goods markets are perfectly efficient, prices could respond to market pressures and bring back the RER to its equilibrium level even if the nominal exchange rate does not change.

In reality, the RER can show non-negligible level of misalignment under both fixed and flexible regimes. Under fixed regimes this might be because of nominal price stickiness (Engel, 2010). Under flexible regimes this might be because of incomplete information and “herd instinct” among investors (Edwards, 2011). A number of empirical analyses confirm that the RER can be misaligned irrespective of the nominal regime (e.g. Coudert et al., 2013; Nouira et al., 2011).

While the above findings showed that the RER can be misaligned irrespective of the nominal regime, others focused on whether a given regime is more prone to misalignment than others. Dubas (2009) showed that misalignment is the most marked in developing countries and that *free floating* leads to much *more* misalignment. In contrast, Coudert and Couharde (2009) and Holtem oller and Mallick (2013) found that the *fixed regime* induces *more* misalignment than the floating. Beside the difference in the econometric approaches and the samples coverage, the contrast between the results of these studies might be due to their focus only on one dimension (nominal exchange rate regimes) to explain misalignment. The literature (e.g. Collins, 1996) suggests that the accepted or tolerated degree of RER misalignment depends on other factors such as political economy considerations, inflationary tensions or even current “climate of ideas”.

In this paper, we focus, in addition to exchange regimes, on two factors that the recent literature suggests as explaining differences in the accepted or tolerated degree of RER misalignment. These factors are institutional quality and financial development. For instance, Rodrik (2008) recommended a strategy based on an active disequilibrium exchange rate when domestic institutions are weak. Aghion et al. (2009) and Elbadawi et al. (2012) found that effect of exchange rate misalignment on growth is smaller the well-developed is the financial system. Such lower cost of misalignment might make the country relatively more tolerant to misalignment.

The analysis is conducted for 51 developing countries over the period 1980–2010. The focus on developing countries is motivated by the fact that misalignment is much more marked in these countries

¹ The difficulty in identifying a significant effect of volatility might reflect the availability of hedging instruments against exchange rate risk, or the adaptability of multinationals. Misalignment generates uncertainty, against which there is little possibility of insurance (Frankel and Goldstein, 1989).

² In reality, exchange rate can be adjusted under fixed regimes. However, for political economy reasons it may be costly to adjust a fixed exchange rate (Collins, 1996).

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