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Inflation targeting or fear of floating in disguise? A broader perspective

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Abstract

Calvo and Reinhart [Calvo, G., Reinhart, C., 2002. Fear of floating. Quarterly Journal of Economics 117, 379–408] argue that many countries claim to float but actually display a "fear of floating" (FF) and that credible inflation targeting (IT) and FF are identical regimes. We analyze exchange rates, reserves, interest rates and inflation across 88 exchange rate regimes for 20 countries. We find IT is empirically distinguishable from fixed, floating, managed floating, and FF regimes. Credible IT appears to be more similar to floating and managed floating than to fixing or FF. Being able to identify these regimes accurately allows one to distinguish between cases where countries claim to IT but actually FF.

JEL classification: E52; E58; F41; F31

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1. Introduction

Calvo and Reinhart (2002), hereinafter C&R, argue that the bipolar view that exchange rate regimes today tend to be either fixed or floating is not accurate. In particular, they show that many regimes that claim to float actually use the domestic interest rate to

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prevent large fluctuations in their currency's value. While not fixing their exchange rate in the traditional sense, neither are these countries allowing it truly to float. C&R term such behavior fear of floating (FF).

The problem with C&R's framework is that it does not distinguish between a credible inflation targeting (IT) regime, a fixed exchange rate (FIX) regime, and FF. Their analysis is based on a model which argues that credible IT is identical to FF. In their words, "in this setting inflation targeting can explain fear of floating." (Calvo and Reinhart, 2002, p. 399). Since the rate of inflation and the rate of currency depreciation are identical in their model, it follows that IT, which targets inflation, and FIX, which targets the depreciation rate, are identical. One thus arrives at the conclusion that credible IT, FF and FIX are three equivalent regimes. Rather than clarify matters, this complicates attempts to classify *de facto* exchange rate regimes based on their work since their argument is that these regimes, when fully credible, are indistinguishable from one another.

The focus of this paper is on the differences between IT from FF. We develop a simple theoretical model to help organize our data. The essence of the model is an open economy Taylor rule for a strict IT regime. That is, it focuses solely on differences between the realized inflation rate and the inflation target, not on the output gap.[1] In this framework we then show that nominal exchange rate movements feed into overall domestic inflation in an open economy. For this reason alone, IT regimes will sometimes act to fight exchange rate movements, but they will be doing so for inflation reasons. We then add a separate term for exchange rate movements to the Taylor rule to model an FF regime's additional weight on exchange rate movements for non-inflation related reasons. This allows us to distinguish between three regimes – strict IT, strict exchange rate targeting, and FF – all based on different weights in the same Taylor rule. This approach is intuitive and in line with Taylor's (2001) and Edwards's (2006) discussion of classifying open economy Taylor rules.

Based on our analytical framework we extend C&R's analysis to include IT as a separate regime and generate the priors we expect to find in the data. Analyzing the variability of exchange rates, international reserves and nominal and real interest rates we find that IT generally appears to be distinguishable from other regimes. To further investigate how IT is different from other regimes we conduct regression analysis that looks at how the real interest rate responds to domestic currency depreciation, changes in international reserves, and changes in the inflation rate, while controlling for different monetary policy regimes that have been implemented. Our results show that some countries can be identified as FF and, again, that IT is generally distinguishable from FF, FIX, and flex. That IT is identifiably different comes across fairly strongly throughout all of our results.

We believe that our analysis is able to identify IT regimes, especially those that are strict. While our interest here is limited to distinguishing between IT and FF, we do hope that our work contributes to the growing and broader literature on exchange rate regime classification. Other studies that have followed C&R's FF work include Reinhart and Rogoff (2004), Levy-Yeyati and Sturzenegger (2005), and Dubas et al., 2005. These works are all serious attempts to place exchange rate regime classification on more sure footing in general. They all focus on *de facto* classifications as a way beyond the traditional *de jure* classifications used for so long by the IMF. The lessons coming from this line of work is

[1] Later in the paper we briefly discuss how to carry our results over to the case where output gaps are included.