

Exchange rate regime transitions

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Abstract

The “hollowing-out”, or “two poles” hypothesis is tested in the context of a Markov chain model of exchange rate transitions. In particular, two versions of the hypothesis—that hard pegs are an absorbing state, or that fixes and floats form a closed set, with no transitions to intermediate regimes—are tested using two alternative classifications of regimes. While there is some support for the lack of exits from hard pegs (i.e. that they are an absorbing state), the data generally indicate that the intermediate cases will continue to constitute a sizable fraction of actual exchange rate regimes. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Some have argued that the only sustainable regimes are free floating and hard exchange rate commitments—essentially currency boards or monetary unions (Eichengreen, 1994, 1998; Obstfeld and Rogoff, 1995). For instance, Eichengreen (1994, pp. 4–5) says that “... contingent policy rules to hit explicit exchange rate targets will no longer be viable in the twenty-first century... [C]ountries... will be forced to choose between floating exchange rates on the one hand and monetary unification on the other.” Similarly, Obstfeld and Rogoff (1995, p. 74)

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state “. . . there is little, if any, comfortable middle ground between floating rates and the adoption of a common currency.” Hence, in the view of these authors, in the future we will see a disappearance of the middle ground that corresponds to soft commitments to some sort of intermediate exchange rate regime—adjustable pegs, crawling pegs, or bands, and perhaps also managed floating. This view is sometimes called the “two poles” or “hollowing out” (e.g. Eichengreen, 1994, p. 6) theory of exchange rate regimes, and is based on the observation that higher capital mobility makes exchange rate commitments increasingly fragile. However, like the optimal currency area literature, which is essentially static, an explicit or implicit assumption is made that regimes are chosen to last forever, and from this perspective, one would only choose a regime that could be sustained once and for all. Only the hardest peg and the absence of any exchange rate commitment whatsoever are likely to qualify on that basis. Thus, Eichengreen (1994, p. 5), states “This will rule out the maintenance *for extended periods* of pegged but adjustable exchange rates, crawling pegs, and other regimes in which governments pre-announce limits on exchange rate fluctuations . . .” (italics added).

However, exchange rate regimes, like other aspects of economic policy, are not chosen once and for all. In fact, history shows us that countries change their regimes frequently, either voluntarily or involuntarily.¹ A particular exchange rate regime may suit the country’s needs at the time—for instance, a peg may be the only way to halt a hyperinflation—but eventually be abandoned even though inflation has been brought down, because there has been a substantial loss of competitiveness.² This is the typical sequence with exchange rate based stabilizations—only rarely do they lead to “permanent” pegs. For instance, Poland in 1990 introduced a fixed peg to the dollar to provide an anchor for the price level, which was followed a year later by a crawling band introduced to limit appreciation of the real exchange rate, and, more recently, has moved to flexibility of the zloty exchange rate. Similarly, Brazil succeeded in eradicating hyperinflation in the mid-1990s through the “real plan”, which involved a dollar peg with a very slow rate of crawl. Since 1999, this regime has been replaced by a flexible rate accompanied by inflation targeting. Only if we believed that countries will never be in the situation of using an exchange peg to disinflate (or never again suffer strong inflationary shocks) would it make sense to argue that countries will never use adjustable pegs as a temporary strategy, but instead will always be at one of the two poles.³

¹ For instance, Klein and Marion (1997) look at the duration of *pegs* (not *regimes*, as is done here), and find that the Latin American pegs in their sample last on average 10 months.

² There have been few formal attempts to model transitions between regimes. A notable exception is Bhandari et al. (1989).

³ Of course, using a peg in this way requires an exit strategy, something considered in Eichengreen et al. (1999).

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