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Verifying exchange rate regimes

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Abstract

Credibility and transparency are at the core of the current debate on exchange rate regimes. Among the reasons why intermediate regimes have fallen out of favor, a possibly important one is that they are not transparent: it is difficult to verify them. This paper investigates how difficult it is for investors to verify from observable data if the authorities are in fact following the exchange rate regime that they claim to be following. Of the various intermediate regimes, we focus on the case of basket pegs with bands. Statistically, it can take a surprisingly long span of data for an econometrician or an investor to verify whether such a regime is actually in operation. We find that verification becomes more difficult as the regime's bands widen and/or more currencies enter in the basket peg. At the other extreme, we also analyze regimes announced as free-floating, and find that in some cases the observed exchange rate data are consistent with the announced regime.

JEL classification: F31; F32; F33; F36
Keywords: Verifiability; Transparency; Exchange rate regimes; Basket peg; Bands; Target zone; Floating

1. Introduction and the corners hypothesis

The choice of exchange rate regime—floating, fixed, or somewhere in between—is an old question in international monetary economics. But the steady increase

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in magnitude and variability of international capital flows has complicated the question. This is particularly the case for the developing countries that in the 1990s became full-fledged participants in international financial markets.

A major new element in the debate is the proposition that emerging market countries are, or should be, abandoning basket pegs, crawling pegs, bands, adjustable pegs, and various combinations of these. The currently fashionable view is that countries are being pushed to the "corners," the extremes of either free floating or firm fixing. The intermediate regimes are said to be no longer viable. This proposition is variously called the hypothesis of the vanishing intermediate regime, the missing middle, or the corners solution. Its life history has gone from birth to conventional wisdom in a remarkably short period of time.

The motivation of this paper is the observation that, as fashionable as this proposition has become, few of its proponents, if any, have offered an analytical rationale for it, let alone a fully worked out theoretical model. Our aim is to offer a possible theoretical rationale. We seek to introduce the notion of *verifiability*, and to suggest that a simple peg or a simple float may be more readily verifiable by market participants than a more complicated intermediate regime. Verifiability is a concrete instance of the more general principle of "transparency" that is so often invoked in recent discussions of the new international financial architecture but so seldom made precise.

1.1. Motivation

Consider the exchange rate regime that a number of emerging markets had in the 1990s: a band around a central parity that itself is a basket with a rate of crawl. So far, as existing theory is concerned, the complexity of this arrangement has no implications for its credibility. But, in truth, when a central bank announces a regime of this type, the public has no way of verifying quickly, by observing the exchange rate, whether the central bank is doing what it claims to be doing.

A central bank does not earn credibility merely by announcing a monetary regime with a nominal anchor such as the exchange rate, even if its intentions are sincere. The public will judge credibility from data available to it. Easily verifiable regimes can reduce uncertainty, since economic agents are able to observe the government's actions. So they have an important piece of information regarding the behavior of the exchange rate. Reduced uncertainty does not necessarily imply that the exchange rate is more sustainable, however it can influence future investment and consumption decisions.

If the announced exchange rate regime is a simple dollar peg, a market participant need only check that the exchange rate today is the same as the exchange rate yesterday, in order to verify that the central bank is indeed following its announced policy. If the announced regime is a pure float, a participant can essentially check every month whether the central bank has intervened in the market by seeing whether its reserve holdings have changed.