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Exchange rate regime durability and performance in developing versus advanced economies ☆

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Abstract

Drawing on new data and advances in exchange rate regimes' classification, we find that countries appear to benefit by having increasingly flexible exchange rate systems as they become richer and more financially developed. For developing countries with little exposure to international capital markets, pegs are notable for their durability and relatively low inflation. In contrast, for advanced economies, floats are distinctly more durable and also appear to be associated with higher growth. For emerging markets, our results parallel the Baxter and Stockman classic exchange regime neutrality result, though pegs are the least durable and expose countries to higher risk of crisis.
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1. Introduction

This paper offers a distinct new twist to the existing academic and policy literature on the durability and performance of alternative exchange rate regimes by drawing on new data and on a new de facto approach to classifying exchange rate regimes (see Reinhart and Rogoff, 2004).[1] Although there are many nuances, overall our results suggest that for relatively poor countries with little access to international capital markets, pegged exchange rate regimes work surprisingly well, delivering both relatively low inflation and relatively high exchange rate regime durability. This finding is in contrast to the growing conventional policy wisdom that pegs are universally unstable and crisis prone. However, we also find that as countries become richer and more financially developed, they benefit by moving to more flexible exchange rate systems. Indeed, for advanced economies, flexible exchange rate systems are remarkably durable and (controlling for other factors) yield somewhat higher growth without higher inflation. For emerging markets, the exchange regime does not appear to have a systematic effect on inflation or growth, although—in line with conventional wisdom—pegs are distinctly more vulnerable to banking and exchange rate crises.

Our results also indicate that, in general, exchange rate regimes have been steadily becoming less durable since the mid-1970s, with emerging markets experiencing the most instability. An important exception, however, is advanced economies, for which durability has increased, particularly for flexible rate systems. We also observe a broad trend towards exchange rate regimes with intermediate levels of inflexibility (in contrast to the once fashionable bi-polar hypothesis). Extrapolating out our estimated exchange rate regime transition matrices suggests that pegs, which today account for roughly 40% of all developing country and emerging market exchange rates, will account for only 25% of all regimes in 2020, with intermediate regimes taking up the slack.

In the next section, we discuss alternatives to regime classification and then present evidence on regime durability for all countries and also for developing and emerging market economies. We turn to the evidence on regime performance—evaluating performance in terms of inflation, growth, and crisis outcomes, and differentiating once again between developing, emerging, and advanced economies. It is important to note that whereas one's perspective on regime durability can be quite sensitive to the particular classification system chosen, our results on regime performance are much less sensitive. Rather, the key factor underpinning our results is our three-way grouping of countries into developing, emerging, and advanced. The final section concludes.

[1] The distinction between stated (de jure) and actual (de facto) policies has received considerable prominence recently, with contributions from Levy-Yeyati and Sturzenegger (2002, 2003) and Reinhart and Rogoff (2004). The IMF itself now publishes regime descriptions that lean towards the de facto characterization. However, de facto measures vary considerably, depending on the methodology used to assess regimes.

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