



Choice of exchange rate regime in transition economies: An empirical analysis

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In this paper we identify the main determinants of the exchange rate regimes in transition economies (TEs). We use an ordered logit model for the official (*de jure*) and the actual (*de facto*) exchange rate classifications and find that the *de facto* regimes describe better the exchange rate strategies implemented in TEs. In addition, economic size and geographical concentration of trade are important determinants of exchange rate regimes. Furthermore, consistent with the sustainability hypothesis, countries experiencing increasing inflation and having higher budget deficits favor flexible regimes. Moreover, having a more developed financial sector increases the likelihood of choosing floating exchange rates. Finally, we find that countries with stronger governments and higher political stability favor pegs. *Journal of Comparative Economics* 34 (3) (2006) 484–498. Center for Economic Studies, Naamsestraat 69, 3000 Leuven, Belgium. © 2006 Association for Comparative Economic Studies. Published by Elsevier Inc. All rights reserved.

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1. Introduction

The choice of an exchange rate regime is a recurring issue in international macroeconomics. Recently, the currency crises in Asia, Russia, Brazil and Argentina have increased interest in this topic. Based on these experiences, Fisher (2001) concludes that intermediate exchange rate regimes are crisis-prone in emerging market economies. Hence, such countries should opt for

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the corner solutions of the spectrum of exchange rate regimes, namely either hard pegs or pure floats.¹ As a subset of emerging market economies, transition economies (TEs) are moving from a centralized economy to an open market economy. As such, these countries are embarking on economic reforms that aim at improved economic performance levels along with transparency and efficiency in the capital markets. However, this group of countries is not homogeneous. Some TEs, e.g., the new European Union (EU) members, have virtually finalized their transition process. Others, e.g., the Commonwealth of Independent States (CIS), have implemented stabilizing reforms relatively recently. Exchange rate regimes also differ considerably among TEs with countries choosing currency pegs or free floats or variations in between.

In this paper, we investigate the determinants of exchange rate regimes in TEs, proceeding in two steps. First, we consider both modern and traditional approaches to the choice of an exchange rate regime and compare their abilities to explain the existing exchange rate regimes in TEs. The traditional approach consists of the theory of an optimum currency area (OCA) pioneered by [Mundell \(1961\)](#) and [McKinnon \(1963\)](#). Among the modern perspectives, we consider the impossible trinity view, the currency crises approach, and the political economy view.

Second, we classify the choice of exchange rate regime according to the officially announced or de jure type and the actually implemented or de facto policy. [Calvo and Reinhart \(2002\)](#) demonstrate that the lack of credibility of monetary authorities in emerging economies often leads to a fear of floating phenomenon. As a result, many countries that announce floating exchange rate strategies do not apply them in reality. Alternatively, [Levy-Yeyati and Sturzenegger \(2005\)](#) argue that a country can manifest a fear of pegging behavior by claiming to have a pegged exchange rate but undertaking frequent changes in parity. We take into account these potential discrepancies by using both de jure and de facto classifications. Furthermore, we enlarge the scope of classification of exchange rate regimes by distinguishing between a hard peg and a soft peg. This additional category is important to the corner-solution hypothesis, according to which, the authorities' commitment to the peg is crucial for the sustainability of the fixed exchange rate.

To test these hypotheses, we use an ordered logit model for an unbalanced panel of 23 TEs between 1993 and 2002.² Our reason for choosing 1993 as the starting date is unavailability of data for earlier years. The remainder of the paper is organized as follows. In the second section, we describe the evolution of exchange rate strategies in TEs and the discrepancies between de facto and de jure classifications in these countries. In Section 3, we review the theoretical hypotheses based on the different approaches to the choice of an exchange rate regime. In Section 4, we develop the baseline econometric model and we present the results of our estimations in Section 5. Finally, Section 6 concludes with policy implications.

2. De jure and de facto exchange rate regimes in transition economies

Initially, we discuss the rationale for using de jure and de facto classifications for exchange rate regimes in TEs. Then, we describe the evolution of regimes in these countries based on these two categories. Numerous empirical studies, e.g. [Calvo and Reinhart \(2002\)](#), [Gosh et al. \(1997\)](#)

¹ The proponents of the corner-solution hypothesis emphasize an increasing role of pure floats and hard pegs as sustainable choices for emerging market economies. All the other exchange rate regimes, called vanishing middle, are considered to be unsustainable in the long run.

² The country list is: Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia, Tajikistan, Turkmenistan, and Ukraine.

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