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The choice of exchange rate regimes in developing countries: A multinomial panel analysis

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Abstract

This paper analyses the choices of exchange rate regimes in developing countries since 1980. Static and dynamic random-effects multinomial panel models are estimated using simulation-based techniques. Explanatory variables include OCA fundamentals, stabilization considerations, currency crises factors, and political and institutional features. The results reveal strong state dependence in regime choices. We also find evidence for non-monotonic relationship between regime determinants and the degree of regime flexibility.
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1. Introduction

The choice of exchange rate regimes has long been a controversial topic among academic economists and policy makers. For most developing countries, it is commonly regarded as their single most important macroeconomic policy decision, which strongly influences the making and efficacy of other macroeconomic policies. The collapse of the Bretton Woods System in 1973 provided countries with a far wider range of choices than before, but many countries

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continued to apply some kind of exchange rate pegs. Since the mid-1980s a trend toward more flexible regimes has emerged. However, independently floating exchange rates comparable to those of the major international currencies remain rare in the developing world. Instead, various types of intermediate arrangements have been adopted in attempts to combine exchange rate stability with policy flexibility.

The variation in exchange rate regimes has generated research interest concerning the determination of these choices. The Optimum Currency Area (OCA) theory of the 1960s views the exchange rate primarily as an expenditure-switching device and develops a list of criteria for favouring fixed-rate against flexible-rate regimes, such as the absence of asymmetric demand shocks, high factor mobility (Mundell, 1961), small economic size and high economic openness (McKinnon, 1963), and high production diversity (Kenen, 1969). The literature of the 1970s focuses on the automatic-stabilizer property of exchange rates and concludes that fixed-rate (flexible-rate) regimes perform better in terms of output stability if nominal (real) shocks are the main source of disturbances (Boyer, 1978; McKinnon, 1981). Following the analysis of Barro and Gordon (1983) on the credibility of monetary policy, the literature in the 1980s discusses the possibility of using exchange rates as nominal anchor to improve the credibility of the domestic monetary authority's efforts to contain inflation (Goldstein, 1980; Melitz, 1988; Fratianni and von Hagen, 1992).

Empirical research on exchange-rate regime choices started in the late 1970s, when more diverse regime choices began to be observed. The early studies selected potential regime determinants based mainly on the OCA criteria (Heller, 1978; Dreyer, 1978), while those in the 1980s added variables reflecting different types of shocks and stabilization strategies (Melvin, 1985; Savvides, 1990). Some authors also included institutional and political variables as potential regime determinants (Edwards, 1996; Bernhard and Leblang, 1999; Méon and Rizzo, 2002). A comprehensive approach covering a wide range of regime determinants is adopted by many recent studies (Rizzo, 1998; Poirson, 2001; Juhn and Mauro, 2002; Von Hagen and Zhou, 2005). As summarized in Table 1, the empirical results of these studies seem to be sensitive to the sample composition, data construction, and model specification.[1]

Table 1 indicates that most studies (10 out of 14 under our review) use a simple binary structure (denoted by "B" for regimes) to classify exchange rate regimes into either fixed or flexible ones. Seven studies include intermediate regimes as a separate option and use an ordered-choice classification (denoted by "O"), assuming that the degree of regime flexibility is monotone in the regime determinants. Only two studies use a multinomial-choice structure (denoted by "M"), which is a more general and flexible framework able to capture both the diversity in regime choices and the complexity in the response of regime choices to the changes in the determinants.

One commonly used estimation method is cross section analysis (denoted by "CS" for methods). Exchange rate regime choices of a given year are typically explained by the average values of the independent variables over several previous years. While this can dampen the effects of temporary disturbances in the regime determinants and attenuate endogeneity

[1] Many papers use various model specifications to analyse the choices of exchange rate regimes, for which Table 1 either reports the main results, which tend to be robust across specifications, or indicates the changing signs of the coefficients. Some papers use explanatory variables not very common in other studies, which are not included in the list of variables here. It should also be noted that some variables, especially real and nominal shocks, have different proxies in different studies. To ease comparisons across studies, Table 1 reports the qualitative impact of each variable on the probability of adopting a fixed or pegged exchange rate regime.

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