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Determinants of exchange rate regime switching

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Exchange rate policy in many emerging markets shifts between a stronger and weaker commitment to peg. This observation raises the following questions, which we address in our paper: Does intervention policy exhibit switching? And if so, what causes policy to shift? The theoretical literature increasingly points to the critical importance of financial fundamentals (Chinn, M.D., Kletzer, K.M., 2001. Imperfect information, domestic regulation and financial crises. In: Glick, R., Moreno, R., Spiegel, M. (Eds.), *Financial Crises in Emerging Markets*. Cambridge University Press, Cambridge, pp. 196–237; Dooley, 2000; Chang, R., Velasco, A., 2005. Monetary policy and the currency denomination of debt: a tale of two equilibria. Kennedy School of Government Working Paper Series, Harvard University, Cambridge, Massachusetts; among others). Direct empirical validation to date is limited, however, although relevant intuitions come from duration and indicators literature (Kaminsky, G.L., Reinhart, C.M., Vegh, C.A., 2004. When it rains, it pours: procyclical capital flows and macroeconomic policies. NBER Macroeconomics Annual, National Bureau of Economic Research, Inc.; Domac, I., Peria, M.S., 2003. Banking crises and exchange rate regimes: is there a link? *Journal of International Economics* 61, 41–72; Tudela, M., 2004. Explaining currency crises: a duration model approach. *Journal of International Money and Finance* 23, 799–816). We use a panel of quarterly data starting 1985 through 2004 for 14 countries, mainly from Latin America and East Asia, and adopt a novel two-step empirical strategy. First, we apply regime switching methods to two simple indices of central bank exchange rate policy. This generates likelihoods of high and low intervention. In the second step, we

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establish the variables that determine these probabilities. We find strong evidence that the economy's balance sheet and economic performance determine the likelihood of switching in the exchange rate regime. Specifically, an increase in reserve currency debt relative to assets raises potential capital losses from devaluation and reduces the probability of switching to a low intervention regime, as does a decline in growth. The purpose here is not to present an alternative regime classification (Levy-Yeyati, E., Sturzenegger, S., 2005. *Classifying exchange rate regimes: deeds vs. words*. *European Economic Review* 49, 1603–1635; Reinhart, C.M., Rogoff, K., 2004. *The modern history of exchange rate arrangements: a reinterpretation*. *Quarterly Journal of Economics*, Available at: <http://www.puaf.umd.edu/faculty/papers/reinhart/papers.htm>), but to establish the relative importance of different constraints on the central bank, which has policy implications. The empirical approach and specification is flexible to whether intervention is discrete or gradual and to whether or not the central bank sterilizes.

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1. Introduction

Policy makers' in emerging markets have the usual macroeconomic objectives: high growth, low inflation, and a stable economic environment. In emerging markets, exchange rates have often been used to anchor inflation. Unfortunately, exchange rate based stabilizations have often ended in crises. The literature on exchange rate policy in small, open economies has developed largely in response to the currency and financial crises experienced by, among others, Mexico (1994–1995), several East Asian economies (1997–1998), Brazil (1999), and Argentina (2001). Quite a number of these countries moved from crawling pegs to fixed regimes. In other cases, currency boards terminated in large devaluations, which in turn gave way to managed floats or “hard pegs.”

In each of these cases, crisis occurred because continued compliance to the peg carried a net cost. The latest generation of crisis models provides several explanations as to why the net cost of fixing the exchange rate might be high. For example, dwindling foreign reserves relative to the central bank's hard currency contingent liabilities may cause private agents to doubt the sustainability of the central bank's intervention policy, prompting a reallocation of portfolios away from domestic currency assets (Dooley, 2000; Chang and Velasco, 1998, 1999; Céspedes et al., 2004). This situation might easily arise if imperfect financial regulation distorts agent incentives by making it cheap to borrow (Chinn and Kletzer, 2001; Hausmann and Velasco, 2004; among others). The literature increasingly focuses on the interaction between agents' portfolio choices and anticipated exchange rate policy given the regulatory environment (Chang and Velasco, 2005).

Recent papers emphasize that external financing often dries up prior to crises. The “sudden stops” phenomenon (Calvo, 1998) highlights the key role of private agents' asset choices in influencing monetary and exchange rate policy. In the case of a “sudden stop” capital outflows or a sharp drop in capital inflows precede a currency crisis. This leads to a fall in the current account deficit, which must shrink as the external credit constraint tightens. In effect, the currency crisis coincides with a financial crisis. A disturbing implication is that crises associated with sudden stops are also associated with sharper recessions (Calvo and Reinhart, 1999).

It is also widely acknowledged that exchange rate policy in emerging markets tended to switch between a stronger and weaker commitment to peg. These shifts have occurred even though volatile policies may introduce costly uncertainty into the economic environment. Indeed, welfare gains from eliminating policy uncertainty could be as high as nine per cent of trend consumption (Mendoza, 2001). The model presented in Chang and Velasco (2005) provides a clue as to why there is policy variability in economies even when there are large potential gains from stabilization. In their model, domestic agents decide the currency composition of their borrowings while the central bank

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