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Institutional development and the choice of exchange rate regime: A cross-country analysis ☆

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ABSTRACT

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This paper investigates the choice of exchange rate regime by analyzing both *de jure* and *de facto* regime choices for the period 1973–1996. It finds that economic fundamentals, financial and political institutional variables provide relevant guidance for *de jure* regime choices. However, shocks are found to be the determinants of a *de facto* regime choice. The analysis shows that only a highly financially liberalized economy can sustain a corner regime. A partial financial liberalization increases the probability of divergence from the *de jure* regime in the face of various shocks, but an increase in the level of financial reforms decreases the probability of divergence. Moreover, regime choices are influenced by the IMF and regional financial architecture. The political institutions play an important role in the choice of a regime; however, their role varies with the level of financial development. *J. Japanese Int. Economies* **23** (1) (2009) 56–70. Bangladesh Institute of Development Studies (BIDS), E-17 Agargaon, Sher-e-Bangla Nagar, Dhaka 1207, Bangladesh.

1. Introduction

The relationship between financial structure and the choice of a currency regime has long been studied. A country with an underdeveloped financial system often faces higher inflation, lack of debt

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sustainability, a fragile banking system, and macroeconomic and exchange rate volatility. These structural features make it difficult for the country to adopt a floating exchange rate regime as a solution of the classical "trilemma",[1] but also make fixed exchange rate regimes prone to crises when capital is internationally mobile. In such countries, sharp currency depreciation alters the domestic currency value of their external debt, which increases "liability dollarization" and leads to "balance sheet" effect (Eichengreen and Hausman, 1999). If liability dollarization causes problems under a floating regime, it simultaneously makes fixed exchange rate regimes harder to maintain. The financial fragility arising from unhedged foreign debts exposes fixed exchange rate regimes to speculative attack through a number of channels—one of which is the resulting vulnerability of the banking system to depositor panic. Therefore, countries with weak financial institutions often face difficulties in choosing and sustaining either a fixed or a floating regime, and therefore diverge from their *de jure* regime.

Empirically, one should observe that countries that peg are those that are in need of an anchor and do not have the necessary institutions needed to maintain macroeconomic stability. On the other hand, if countries are more prone to real volatility, they are likely to adopt floating regime. These countries deviate from their announcements not only because they cannot maintain conditions compatible with pegs or floats, but they do not have the necessary financial and political institutions as well. Hence, development of institutions, both financial and political, remains a key policy option for sustaining a currency regime.

Although economists provide various answers to the choice of a currency regime based on economic fundamentals, shocks, financial structure and political institutions, most of the existing studies analyze the choice of exchange rate regime by using *de jure* regime data without proper considerations given to the *de facto* regime choice (or the divergence from the *de jure* regime). For this reason, some authors cast doubt on the validity of earlier results on the choice of a regime (Rogoff et al., 2003). The objective of this study is to explain the dynamics of divergence, and within that context, to identify the factors that lead to the divergence in particular, and the choice of a regime in general.

A few studies have attempted to explain the divergence. Calvo and Reinhart (2002) argue that countries with high unhedged foreign currency denominated debt or high exchange rate risk exposure have an incentive to peg even if they are officially floating, terming this as "fear of floating". On the other hand, some countries are experiencing *fear of pegging*—a fear that pegging would invite speculative attacks as a result of destabilizing misalignment (Levy-Yeyati and Sturzenegar, 2002; Genberg and Swoboda, 2005). In a political economy study, Alesina and Wagner (2006) show that the lack of quality of a country's legal and political institutions lead countries to diverge from their *de jure* regime.

Even though these studies provide some explanations to the divergence, they have not studied the choice of a *de facto* regime (or reasons of divergence) directly. Another potential problem with existing studies is that they appear to suffer from omitted variable bias as they do not consider all four kinds of relevant variables, such as shocks, economic structure, financial and political institutions together either in the analysis of divergence or in the choice of a *de jure* regime. Therefore, it is not clear from these studies whether institutional aspect (either financial or political or both) is crucial for the choice of a regime. The empirical analysis of this study addresses these issues in explaining the choice of a regime.

The analysis is approached from two different angles. First, the determinants of a *de jure* regime choice are investigated, and second, the reasons of divergence from the *de jure* intermediate and floating regimes are analyzed by considering four categories of relevant explanatory variables: shocks, structure, financial and political institutions.[2] This empirical approach allows for obtaining consistent estimates of parameters in explaining the choice of a regime. For empirical analysis, the ordered logit

[1] This impossible trilemma states that a country must give up one of the three goals: exchange rate stability, monetary independence and financial market integration, that is, a country cannot have all three simultaneously.

[2] The divergence from fixed regime is not considered as the definition of fixed regime in *de jure* regime classification and *de facto* regime classification is different. While *de jure* fixed category considers both soft and hard pegs, *de facto* fixed category considers only hard fixed regimes such as currency union, currency board and dollarization.