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The political economy of exchange rate regime determination: Theory and evidence

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ABSTRACT

This paper studies exchange rate regime choice from a positive perspective by modeling the interplay of monetary and fiscal policy, credibility and financial market microstructure as factors influencing the decision on *de facto* regime. The model shows how a small open economy reliant on foreign sources of financing is likely to opt for a stable regime. Furthermore, a stable political environment with a high degree of accountability is conducive to choosing a flexible regime. The findings suggest that flexible rather than fixed exchange rate regimes provide more fiscal discipline.

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1. Introduction

What determines the type of exchange rate regime a country chooses? Economic literature has generally addressed this question from a normative point of view. Normative theories attempt to answer the question: What is the optimal exchange rate regime for a country under specific conditions or what regime *should* a country adopt? The question of what *does* determine actual regime choice remains largely unanswered despite a massive body of literature on exchange rate regimes and currency crises. This paper aims to address this gap by adopting a positive perspective on regime choice. The analysis builds a theoretical framework for explaining exchange rate regime choices

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through the interaction of monetary and fiscal policies, credibility issues, political uncertainty and financial markets microstructure.

Bordo (2003) provides a historical overview of the literature on exchange rate regime choice. Among the most prominent normative theories of regime choice is the theory of Optimal Currency Areas (OCA) originally developed by Mundell (1961) and McKinnon (1963). The OCA stream of research determines the optimality of a monetary union based on a set of criteria such as trade links, labor mobility, enhancement of monetary policy credibility, fiscal transfers, and the synchronization of shocks across member states. Optimal regime choice has also been linked to the source of the economic shocks, real or nominal, and the degree of capital mobility. Following the works of Mundell (1963) and Fleming (1962), the main recommendations on regime choice included adopting a floating regime if real shocks prevail, while a fixed regime should be preferable under nominal shocks. At the same time, countries could hope to achieve only two out of three possible regime characteristics comprising monetary independence, an exchange rate peg and free capital mobility. Later Frankel and Rose (1998) pointed towards the endogeneity of OCAs, or the fact that countries may become optimal candidates for a monetary union ex-post, after the implementation of a common monetary regime, even if they do not qualify ex-ante. The reason is that the currency union may enhance trade and the correlation of shocks in member states.

Recent empirical explorations have demonstrated that exchange rate regime choice is no longer viewed as a binary decision between fix and float. Real world exchange rate regimes exhibit a large degree of heterogeneity, even within the same official category. Fixed exchange rates can get realigned frequently or fluctuate in a relatively wide band, while some floats may behave more like a peg. This observation has led to a thorough re-examination of the current and historical exchange rate regime classifications by Calvo and Reinhart (2002), Reinhart and Rogoff (2004) and Levy-Yeyati and Sturzenegger (2005, 2003). This emergent literature differentiates between *de jure* and *de facto* exchange rate regimes. The *de jure*, official or self-declared, regime characterization is represented primarily by the classification system of the International Monetary Fund (IMF).¹ Reinhart and Rogoff (2004) provide the most comprehensive and up-to-date *de facto* regime classification for 153 countries between 1946 and 2001. Levy-Yeyati and Sturzenegger (2005, 2003) provide an alternative *de facto* re-classification of regimes for 183 countries in the post-Bretton Woods period. These studies incorporate measures of actual exchange rate volatility and define regimes in statistical terms, yet retain the notion of regime choice as a discrete variable.² Both investigations find significant discrepancies between *de jure* and *de facto* exchange rate regime classifications, and thus highlight the significance of defining and measuring regime choice in *de facto* terms. For example, the simple correlation coefficient between the official IMF classification and that of Reinhart and Rogoff (2004) for the 1970–2001 period is only 0.42. They find that almost half of official pegs are not *de facto* pegs, and over half of official managed floats are pegs or limited flexibility arrangements. This evidence challenges the previously accepted notion that exchange rate regimes have in general become more flexible in the post-Bretton Woods period.

The recent literature re-examines the performance of different exchange rate regimes primarily in terms of growth and inflation using the new *de facto* classifications in order to identify empirically which regime category is more likely to achieve superior economic outcomes. Hence, it maintains the traditionally normative perspective on regime choice. Theoretical efforts have largely continued to mirror this narrow focus on normative issues of regime choice. For example, a recent paper by Chang and Velasco (2006) continues to restrict attention to the normative evaluation of two alternative policies: fixed or fully flexible exchange rate. The binary view of regime choice does not reflect the reality where very few countries implement a hard peg (e.g., currency board or joining a monetary union) or a truly free float. Empirical papers on *de facto* regime classifications have consistently found

¹ For this official classification see the IMF's *Annual Report on Exchange Rate Arrangements and Exchange Restrictions*. The IMF revised its classification of exchange rate regimes in 1997 and 1999 in order to reflect real world data more accurately. The new classification is more disaggregated and includes a *de facto* peg category.

² There are a number of methodological differences between the two studies. For instance, Levy-Yeyati and Sturzenegger (2003, 2005) classify regimes based on the volatility of exchange rates and international reserves. Reinhart and Rogoff (2004) further differentiate between truly floating and freely falling regime categories, the latter intended to distinguish episodes of high inflation (and currency crises) from normal floating periods.

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