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De facto and official exchange rate regimes in transition economies

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Abstract

This paper provides an empirical investigation on the discrepancies between official and de facto exchange rate regimes in transition economies. We use a probit model to describe the determination of regime discrepancies. We find that ''errors'' in the selection of official regimes as well as the macroeconomic developments calling for conflicting adjustments in exchange rate regimes are important determinants of regime discrepancies.

JEL classification: E42; F31; F33

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1. Introduction

The choice of an appropriate exchange rate regime is a venerable topic in international macroeconomics and finance. Theoretical literature discusses the choice of exchange rate regimes from various perspectives, such as optimum currency areas (OCA), optimal stabilization, monetary policy credibility, and currency crises. Empirical research applies

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theoretical guidelines to explain the observed choices of exchange rate regimes.[1] Most of these studies, however, focus on the official regimes, i.e., those that the governments declare rather than the de facto regimes they actually pursue.[2]

The relation between official and de facto exchange rate regimes is best characterized as one between words and deeds (Levy-Yeyati and Sturzenegger, 2003). Official regimes are those that national authorities annually declare to the IMF as the regimes that they adopt. De facto regimes are those that are actually practiced by the authorities. Until recently, the distinction between official and de facto regimes has largely been ignored in the literature. However, the studies by Ghosh et al. (1997) and Calvo and Reinhart (2002) show that regime discrepancies are common in practice and these discrepancies may last for substantial periods of time. While Ghosh et al. (1997) find that frequent adjustments of the central parity can make an officially pegged exchange rate quite flexible, Calvo and Reinhart (2002) show that heavy foreign exchange interventions can make an officially floating exchange rate very stable.[3]

Why countries choose to practice exchange rate regimes different from their official announcements remains a puzzle in the literature. Calvo and Reinhart (2002) argue that low credibility of the monetary authority is the main reason for the fear of floating. By providing the economy with a transparent and easily verifiable nominal anchor for inflation expectations, stable exchange rates can help weak central banks improve the credibility of their commitment to price stability. Lahiri and Végh (2001) suggest that regime discrepancies result from a trade-off between the cost of foreign exchange market intervention and real output losses due to exchange rate volatility. Their analysis predicts that central banks allow the exchange rate to adjust to small shocks but intervene in the presence of large shocks to avoid excessive exchange rate volatility. Hausmann et al. (2000) explain regime discrepancies by the desire to avoid large exchange rate volatility, a desire which increases with a country's borrowing in foreign currency. At a closer look, however, these arguments contribute more to explaining the desirable degree of exchange rate flexibility and, therefore, the choice of official exchange rate regimes than to explaining discrepancies between official and de facto regimes.

The present paper takes a positive approach to explaining exchange rate regime discrepancies in 25 transition economies during the 1990s.[4] This is an interesting sample. Not withstanding their economic heterogeneity, these countries have many features in common: They all emerged from socialist regimes largely isolated from the world economy at the end of the 1980s; they all faced large macroeconomic imbalances and stabilization problems initially; they all became gradually integrated into international trade and financial markets during the period we consider. Yet, there is quite a variety of exchange rate regimes, both official and de facto, among these countries. von Hagen and Zhou (in press) show that the official regime choices in transition economies can be

[1] See von Hagen and Zhou (2004) for a review of the theoretical and empirical literature on the choice of exchange rate regimes.

[2] Holden et al. (1979) and Poirson (2001) are two exceptions. They analyze the determination of the actual variability of the exchange rate.

[3] They dub this phenomenon as "fear of floating".

[4] It would be ideal to cover more recent years in our analysis. However, due to data limit, especially to the difficulty in obtaining monthly reserve data, we are unable to extend our classification of de facto exchange rate regimes to years after 1999.