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Classifying exchange rate regimes: Deeds vs. words

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Abstract

Most of the empirical literature on exchange rate regimes uses the IMF *de jure* classification based on the regime announced by the governments, despite the recognized inconsistencies between reported and actual policies in many cases. To address this problem, we construct a *de facto* classification based on data on exchange rates and international reserves from all IMF-reporting countries over the period 1974–2000, which we believe provides a meaningful alternative for future empirical work on the topic. The classification sheds new light on several stylized facts previously reported in the literature. In particular, we find that the *de facto* pegs have remained stable throughout the last decade, although an increasing number of them shy away from an explicit commitment to a fixed regime ("hidden pegs"). We confirm the hollowing out hypothesis but show that it does not apply to countries with limited access to capital markets. We also find that pure floats are associated with only relatively minor nominal exchange rate volatility and that the recent increase in the number of *de jure* floats goes hand in hand with an increase in the number of *de facto* dirty floats ("fear of floating").
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1. Introduction

The analysis of the implications of alternative exchange rate regimes is arguably one of the most important questions in international economics. However, our knowledge of this issue from a theoretical point of view, which comprises an extensive literature starting with Mundell's (1961) theory of optimal currency areas, contrasts with the

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relatively weak empirical findings linking exchange rate regimes with macroeconomic performance. One potential explanation for this weakness relates to the way in which countries are grouped according to their exchange rate arrangements.

Most of the empirical discussion on exchange rate regimes has used the *de jure* (legal) regime as compiled by the IMF, which is based on the regime the country declares to be running.[1] However, many countries that *in theory* have a flexible rate intervene in exchange markets so pervasively that *in practice* very little difference exists (in terms of observable performance) with countries that have explicit fixed exchange rate regimes. Conversely, periodic devaluations of pegs in inflation-prone countries are the result of the implementation of monetary policies that are inconsistent with fixed exchange rates and that make the effective regime resemble a flexible arrangement.[2] Moreover, countries that appear to behave according to the declared regime during tranquil times may be tempted to change their course of action once the regime is under stress. Thus, a very different picture of exchange rate regime choices may appear once the international context becomes more volatile.[3]

In this paper, we address these problems by proposing a new *de facto* classification of exchange rate regimes that reflects actual rather than announced policies, which we believe provides an alternative as well as a complement to the standard *de jure* approach.[4] More precisely, we define exchange rate regimes according to the behavior of three classification variables: changes in the nominal exchange rate, the volatility of these changes, and the volatility of international reserves. Underlying the selection of these variables is a textbook definition of exchange rate regimes, where fixed exchange rate regimes are associated with changes in international reserves aimed at reducing the volatility in the nominal exchange rate, and flexible regimes are characterized by substantial volatility in nominal rates with relatively stable reserves. Thus, the combined behavior of these three classification variables should be sufficient to determine the regime to which each country should be assigned at any point in time.

To construct the classification we use a cluster analysis methodology that, once the number of exchange rate regimes to be identified from the data is defined, groups the cases according to similarity in the behavior of the three variables of reference. For example, the cluster with high volatility of reserves and low volatility in the

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[1] See the IMF's *Exchange Arrangements and Exchange Restrictions.* An example of the IMF *de jure* classification can be found in any issue of the *International Financial Statistics*.

[2] As Frankel (1999) points out: "*Out of 185 economies, the IMF classifies 47 as independently floating and 45 as following rigid pegs... Most of those classified as fixed have in fact had realignments within the last ten years... . Similarly, most of those listed as floating in fact intervene in the foreign exchange market frequently*".

[3] Indeed, the relatively new literature on the impact of currency unions on economic performance (Frankel and Rose, 2000; Rose, 2000), where exchange rate misclassifications are virtually nil, has tended to deliver stronger results.

[4] Ghosh et al. (1997) move in this direction when they do not consider as "fixers" countries that experienced substantial adjustments of their exchange rates. Frieden et al. (2001) also modify the standard IMF classification to account for frequent adjusters and for different types of crawls for a group of selected countries. The distinction between *de jure* and *de facto* regimes has been as of late recognized by the IMF: The exchange rate regime grouping reported in the IFS in recent years tries corrects in an ad hoc manner for some obvious misclassifications.

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