

# Exchange rate regimes in Central and East European countries: Deeds vs. words

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We analyze whether de facto exchange rate regimes match de jure regimes in six Central and East European countries. Our first approach is based on the analysis of volatilities of exchange rates, reserves, and interest rates. In the second approach, we analyze movements of the exchange rate compared to those of possible anchor currencies. Our results indicate that Slovenia followed a crawling peg to the Deutsche mark and later to the euro de facto, but the evidence is less clear for the Romanian regime. We confirm that the Polish and the Hungarian regimes are close to the announced ones de facto, although we find some degree of implicit euro targeting for the Czech Republic and Slovakia. *Journal of Comparative Economics* **34** (3) (2006) 467–483. Universität Hannover, Königsworther Platz 1, 30167 Hannover, Germany D-30167; Deutsche Bundesbank, Frankfurt/Main, Germany D-60006.

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## 1. Introduction

Many post-communist countries chose a fixed exchange rate as a tool of its stabilization strategy during the first years of transition. In the late 1990s, most countries moved to more flexible

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arrangements (Sachs, 1996). This strategy adds the benefits from pegging to the anchor currency in the beginning to the ability to cope better with volatile capital movements in the later period (Corker et al., 2000). The Visegrád Group, i.e., the Czech Republic, Hungary, Poland and Slovakia, took this route (Kočenda, 2002). Officially, the Czech Republic and Slovakia opted initially for narrow horizontal bands, while Hungary and Poland chose narrow crawling bands that served the dual objectives of maintaining competitiveness and moderating inflation (Szapáry and Jakab, 1998). Subsequently, these fixed exchange rate regimes became more flexible and, after widening the bands, the Czech Republic (1997), Poland (2000) and Slovakia (1998) declared managed or freely floating exchange rates. Hungary kept a fixed exchange rate during the entire sample period, although the band width was widened substantially. In 2000 the Hungarian forint was re-pegged to the euro; in 2001, the band was widened to 15% and changed from a crawling to a horizontal band to mirror the exchange rate regime envisaged in the Exchange Rate Mechanism (ERM-2). Early in the transition, other countries opted either for completely fixed exchange rates, i.e., the Baltic countries and Bulgaria, or rather flexible regimes, i.e., Romania and Slovenia.<sup>1</sup>

This development follows the bipolar view, which emerged as a consensus mainstream opinion of exchange rate policy.<sup>2</sup> The bipolar view is based on the idea that, in a world of high capital mobility, adjustable pegs may be costly and difficult to defend so that they will be replaced by either hard pegs, i.e., currency boards and currency unions, or absolutely flexible exchange rate systems. According to official classification by the International Monetary Fund (IMF), the share of intermediate exchange rate regimes has declined during the last decade in support of this view, as Fischer (2001) discusses. However, Ishii and Habermeier (2002) point out that what countries say they are doing may not be what they are actually doing. Thus, fear of floating or de facto pegging has been widely accepted, as Calvo and Reinhart (2002) discuss.<sup>3</sup> Hence, the IMF has acknowledge de facto exchange rate regimes since 1999, although the new classification remains a hybrid system combining data on actual flexibility with information on the official policy framework (IMF, 2004). According to this classification, the Slovenian and Romanian exchange rate regimes are crawling pegs even though these two countries announce managed floats officially.

In addition to the standard arguments of reducing transaction costs for external trade and macroeconomic stabilization (Halpern and Wyplosz, 1997), at least two major reasons can be given for why countries may not let their currency float freely.<sup>4</sup> First, small open economies are highly susceptible to exchange rate movements; therefore, the exchange rate must be considered by monetary authorities even if it is not the primary goal of monetary policy (Ball, 1999). Most of the EU accession countries in Central and Eastern Europe belong to this class of countries. Second, in many emerging and transition countries, financial markets are less developed and do not allow domestic firms to borrow in their home currency, which is deemed to be the original sin by Eichengreen and Hausmann (1999). Even if the exchange rate is officially floating, countries will have incentives to peg their exchange rates because their debt is nominated in foreign

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<sup>1</sup> Mussa et al. (2000) discuss the exchange rate arrangements chosen by transition countries.

<sup>2</sup> The bipolar view is also named as the hollowing out hypothesis or the two-corner hypothesis.

<sup>3</sup> Fischer (2001), Reinhart and Rogoff (2004), Levy-Yeyati and Sturzenegger (2005), and McKinnon and Schnabl (2004) also support this view. Rogoff et al. (2004) state that, from an ex post perspective, the de facto exchange rate regime differs from the announced one about 50 percent of the time.

<sup>4</sup> The literature on optimum currency areas surveyed by De Grauwe (2003) suggests that the choice of a fixed exchange rate is reasonable for only a limited number of countries. Therefore, the choice is between a freely floating and an intermediate exchange rate regime.

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