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The dynamics of exchange rate regimes: Fixes, floats, and flips

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Abstract

The impermanence of fixed exchange rates has become a stylized fact in international finance. The combination of the "mirage" view that pegs do not really peg with the "fear of floating" view that floats do not really float generates the conclusion that exchange rate regimes are, in practice, unimportant for the behavior of the exchange rate. This is consistent with evidence on the irrelevance of exchange rate regimes for general macroeconomic performance. Recent studies, however, show that the exchange rate regime matters. This can be understood by considering the dynamics of exchange rate regimes. We demonstrate that the "mirage" view is somewhat misleading and incomplete. Pegs frequently break, but many do last. Also, there is a high degree of flipping, that is, the re-formation of pegs that have broken. Thus, a fixed exchange rate today is a good predictor that one will exist in the future. We also investigate the quantitative effect of fixed exchange rates. While the "fear of floating" view suggests little actual difference in fixed and floating rates with respect to exchange rate volatility, we show that fixed exchange rates exhibit considerably greater bilateral exchange rate stability than flexible rates, both today and in the future.

Keywords: Exchange rate regimes; Fixed exchange rate

JEL classification: F3; F4

1. Introduction

The choice of an exchange rate regime and the consequences of this choice, traditionally represent a central topic in international finance. But, recently, research has called into question the relevance of this line of inquiry. This is demonstrated by two of the more evocative titles in international finance articles published in the last decade, "The Mirage of Fixed Exchange Rates" (Obstfeld and Rogoff, 1995), and "The Fear of Floating" (Calvo and Reinhart, 2002). Obstfeld and Rogoff (1995) suggest that fixed rates are not all that fixed, writing "literally only a handful of countries in the world today have continuously maintained tightly fixed exchange rates against any currency for five years or more." [p. 87] Calvo and Reinhart (2002) argue that floating rates do not really float, rather governments that claim to allow market forces to determine the value of their currencies actually act to minimize exchange rate fluctuations.

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Taken together, these influential articles suggest that the exchange rate regime is, in practice, unimportant and perhaps irrelevant for the actual behavior of the exchange rate. This conclusion is bolstered by empirical research that finds little role for exchange rate regimes in determining major macroeconomic outcomes beyond the real exchange rate (see Mussa, 1986, Baxter and Stockman, 1989, and Flood and Rose, 1995). Altogether, based on these works, there is a general impression that exchange rate regimes — in spite of all the attention they receive — are in some ways unimportant.

In this paper we bolster the traditional view of the importance of the exchange rate regime. One of our central results shows that fixed exchange rates are more substantial than mere mirages; while almost half of the fixed exchange rate spells do not last more than two years, the expected duration of a peg increases dramatically if it survives past that age. Consequently, at any one-time, the set of countries that are pegged includes a large proportion of those with a peg lasting for a relatively long duration. We also show that the distribution of floating exchange rate spells is similar to the distribution of fixed exchange rate spells, with a large number of short-lived floating exchange rate spells and a smaller number of long-lived floating exchange rate spells. An important implication of this is the flipping of pegged rates, that is, the end of a peg is often followed by the reformation of a new peg. This dynamic behavior of exchange rate regimes, when combined with an analysis of the duration of fixed exchange rate spells and floating exchange rate spells, paints a different picture than one would expect from the well-known "mirage" of fixed exchange rates.

The mere classification of annual observations into those categorized as "pegs" and those categorized as "floats" (or, more accurately, non-pegs) would not matter if the "fear of floating" truly limited exchange rate flexibility when countries do not peg. We demonstrate, however, that the magnitude of bilateral exchange rate volatility between a country that has a pegged rate and its base country is quite distinct from bilateral volatility when a country does not peg.[1] Countries that peg have lower multilateral volatility as well, mainly because these countries tend to avoid extreme bilateral volatility outcomes.[2]

Taken together, these two results, on the dynamics of exchange rate regimes and the implications of the exchange rate regime for volatility, implies that a country with a fixed exchange rate today can be expected to exhibit greater exchange rate stability both today and over the course of time. This helps explain some current evidence on the effects of exchange rate regimes, including the significant and positive effect of fixed exchange rates on trade (Klein and Shambaugh, 2006a), the limits that fixed exchange rates place on monetary autonomy (Shambaugh, 2004, and Obstfeld et al., 2005), and the effects of the exchange rate regime on the transmission of terms of trade shocks (Broda, 2004, and Edwards and Levy-Yeyati, 2005), the national price level (Broda, 2006) and inflation (Ghosh et al., 2002). The results presented in this paper also help explain why research has found that the exchange rate regime plays a role in determining the rate of growth (Aghion et al., 2006, Levy-Yeyati and Sturzenegger, 2003, Husain et al., 2005, Di Giovanni and Shambaugh, 2006, and Ghosh et al., 2002) and growth volatility (Ghosh et al., 1997).

Thus, this paper demonstrates the extent to which exchange rate regimes really do matter for exchange rate outcomes, and helps explain the source of effects of recent research demonstrating trade and macroeconomic consequences of exchange rate regimes. It examines the nature of *de facto* exchange rate regimes themselves, studying their duration, dynamics, and the extent they affect the exchange rate. In essence, we try to provide a new set of stylized facts on exchange rate regimes that helps explain why the new wave of empirical evidence on their effects can occur.

2. Exchange rate spells, fixed and floating

A central part of this study, or any other one that focuses on the role of the exchange rate regime, is its definitions of the regimes themselves. It has been well documented that governments' declarations to the International Monetary Fund as to the exchange rate regimes in place are not always accurate (see, for example, Calvo and Reinhart, 2002). Therefore, in this paper we rely on *de facto* exchange rate behavior rather than *de jure* declarations of whether a country has a fixed or a flexible exchange rate.[3]

[1] This is not to argue that no countries manage their non-pegged exchange rates, or that no countries misdeclare their regimes, but to say that some countries actually do float and their exchange rates are notably more volatile than the pegs.

[2] As discussed below, implications of these distinct effects between bilateral and multilateral outcomes relate to differences in trade and macroeconomic outcomes since bilateral volatility affects bilateral trade and macroeconomic stability while economic growth, for example, may require a broader effect across many sectors that is more closely associated with multilateral stability.

[3] Our focus is on new stylized facts for *de facto* regimes. There is another strand of research that explores why *de facto* activities and *de jure* declarations can conflict. Alesina and Wagner (2006) investigate why some countries behave more restrictively than they declare or vice verse. Genberg and Swoboda (2005) discuss reasons why a government may peg an exchange rate without declaring that as its goal which suggests that *de jure* declared regimes may not really represent the true goals or actual intent of a government.