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Exchange Rate Regimes: Choices and Consequences

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Before writing a review of this splendid book I should make the proper disclaimers that it is written by two of my IMF colleagues and a Georgetown Professor. While working in the International Monetary Fund, I wrote an IMF Working Paper with Anne-Marie (her husband Holger Wolf dispensing generous comments) and co-authored a few IMF Working and Occasional Papers where Atish Rex took the lead. Having said that, I still think that this is a splendid book, one that should not be left out by anybody who is interested in understanding the role of exchange rate regimes for the macroeconomic performance.

The authors (I will denote them GGW) carefully planned an unabashedly empirical book. Exchange rate regimes are one of those topics where economists like to say that "the theoretical literature is way ahead of the empirical literature". Indeed, not a single economics undergraduate student in the past 30 years has escaped the theoretical wisdom of the Mundell-Fleming model and the Krugman-Obstfeld textbook (International Economics: Theory and Policy. 6th Edition. Pearson Addison Wesley, 2002) has been making a similar mark on the past few generations of graduate students. Yet there is remarkable schism between the abundance of theoretically possible effects and empirically observed and generally agreed "stylized facts". In other words, can we believe those models?

Who is going to have lower inflation, countries with fixed exchange rates or with flexible ones? And how about economic growth? Is it true that monetary policy is impotent under fixed exchange rate regimes and powerful only under floating regime, as suggested by the Mundell-Fleming model? How about semi-fixed regimes, which tend to be the most frequently chosen ones where the Mundell-Fleming model is largely silent? And why there have been some many regimes in the first place – their design surely must matter for something? The list of potential questions is long, but GGW provide surprisingly coherent, even though sometimes disturbing, answers.

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The book contains – beside an introduction, conclusions, annex tables, and a CD-ROM with all the data used in the book – a total of seven chapters. The first two chapters provide a short history of the international monetary system, with the obvious stress on the post-war and post Bretton Woods arrangements, and a sketch of the basic theories of exchange rate regimes. Those introductory chapters are quite useful for an uninitiated reader. First, it makes the reader realize that the possibility of choosing an exchange rate regime is a fairly new one: up until the early 1970s, first the gold standard and then the Bretton Woods system of U.S. dollar-pegged exchange rates were the norm applicable to practically all nations.

The brief, 16-page theoretical chapter might seem disappointingly simple, but the reason GGW decided to forego many of the issues floated in the theoretical literature is obvious: they are irrelevant for a policymaker deciding between "pegged" or "floating" regimes. Policymakers' choices between those two regimes are still constrained by the options laid out by the Mundell-Fleming model: either a reduction in exchange rate volatility or a loss of an independent monetary policy. In other words, fixed regimes provide greater output stability in the face of nominal (monetary) shocks, while flexible regimes are better at absorbing real shocks.

The rich array of options under the Mundell-Fleming model is further extended when the issues of credibility or an optimal currency area are taken into account (for example, inflation can be lower under pegged regimes either because the money supply grows slower or because the peg gave an additional credibility effect to the monetary authorities, lowering inflationary expectations). An issue in itself is the question of the transition from one regime to another. How expensive are exits from pegged regimes and does it pay off to maintain the peg at all costs? GGW do not hide the ambiguity of the theoretical literature, on the contrary, they use it to point out a very rich set of permissible outcomes that can be validated only by empirical evidence.

The first of the five empirical chapters (Chapter 4) explores the validity of the trivial textbook dichotomy between "fixed" and "floating" regimes and finds that squeezing all those diverse regimes into two boxes does not work very well. The first issue that some regimes are neither fixed nor flexible is dealt with by defining an intermediate category or categories, leading to three-way or six-way classification of exchange rate regimes. The second issue, that of *de iure* and *de facto* classifications, in more difficult to tackle. Clearly, some countries cheat by announcing that their currencies are allowed to float freely, while intervening at the same time to keep the exchange rates from moving one way or another. Recently, several researchers provided empirical alternatives to the official announcements by basing the regime classifications on observed volatility of national exchange rates. GGW prefer, perhaps surprisingly, the *de iure* approach, because of its signaling and expectations effect, nevertheless check the robustness of their results by the *de facto* classifications.

The next empirical chapter takes an initial look, mostly using graphs, at the main stylized facts about the exchange rate regimes and the macro economy, and already finds some surprises. Floaters experience higher nominal volatility than peggers, however, the nature of volatility differs according to the level of development: while high-income countries experience merely short-term noise, low-income countries' volatility appears to reflect inflation differentials. Real exchange rates reflect that finding and longer-term exchange rate volatility of low-income countries is lower when the currency floats! While the growth evidence is ambiguous, inflation results are quite robust – with the exception of industrial countries, floating regimes are associated with higher inflation as compared to pegged regimes.

In Chapter 6 the authors put the initial results to rigorous econometric tests by estimating reduced-form inflation and growth regressions. Although the specification of both equations is fairly standard, no major effect seems to be omitted and GGW control for external shocks, central bank independence, fiscal dominance, and so on. Money supply is appropriately endogenized in inflation regressions as is the choice of the exchange rate regime in growth regressions.

The graph-based results from Chapter 5 survived the regression scrutiny: inflation is lower under fixed exchange rate regimes, both through the discipline effect (lower money supply growth) and the credibility effect (lower expected depreciation). At the same time, the growth record is mixed, however, as peggers were more likely to experience output volatility. In summary, it looks that the Mundell-Fleming model is alive and well.

Chapter 7 takes a closer look on exchange rate-based stabilizations, which are, on the one hand, credited with fast disinflations and, on the other hand, blamed for lower interest rates triggering consumption booms, leading to an eventual collapse of the peg. The GGW sample does not support the criticism and peggers appear to be as likely as floaters to fail in their stabilization efforts. The authors augment their panel analysis with three country studies: Bulgaria, Turkey, and Argentina. If anything, these case studies show that neither the peg nor a currency board are a magic bullet – if there remain underlying structural weaknesses, the stabilization effort is unlikely to succeed irrespective of the regime choice.

The penultimate chapter deals with the prickly issue of regime changes. Obviously, much of the success of fixed-rate regimes depends on the credibility of the regime. "Fear of exit" may pressure policy makers to procrastinate, delaying the inevitable adjustments, and ultimately making the crisis deeper than necessary. The 1997 Czech currency mini-crisis, although not mentioned in this book, is a good example of this type of behavior. GGW in the chapter correct a few more stylized facts: currency crises are much more frequent under floating regimes; however, their output consequences are more severe under pegged regimes. Surprisingly, this ranking is reversed for the effects of banking crises under those regimes.

The short final chapter summarizes the results and is followed by data annexes and also includes a CD-ROM containing all the data used in the book.

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I found the book written by Atish Ghosh, Anne-Marie Gulde, and Holger Wolf extremely helpful in organizing the stylized facts about the impact of exchange rate regimes. The verdict may be surprising for some, but it was to be expected: fixed-rate regimes seem to do somewhat better than flexible regime, but the former comes with major risks attached if not executed correctly. This is certainly a good message to remember in the run-up to the Euro. Ultimately, this book is about testing the usefulness of the Mundell-Fleming model and, with some relief, the economists can sleep well – the empirical evidence largely supports the model findings. The choice of the regime is important and it is good to know the likely outcomes of policy makers' decisions. They and their advisors would omit this book at their own peril.

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