



Exchange Rate Regimes:

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WHETHER he knows it or not, the owner of a Pacific island surfboard shop thinking in March about the cost of buying 100 surfboards from his California supplier in July should care about his country's exchange rate regime. A country's exchange rate regime governs its exchange rate—that is, how much its own currency is worth in terms of the currencies of other countries. If the surfboard shop owner's country has a fixed exchange rate regime, under which the value of the local currency is tied to that of the U.S. dollar, then he can be confident that the price of surfboards in his currency won't change over the coming months. By contrast, if his country has a flexible exchange rate regime vis-à-vis the U.S. dollar, then its currency could go up or down in value during the change of seasons and he may want to allocate more, or less, local currency for his forthcoming surfboard purchase.

If you extend the above scenario to all cross-country transactions, you can see that the exchange rate regime has a big impact on world trade and financial flows. And the volume of such transactions and the speed at which they are growing highlight the crucial role of the exchange rate in today's world, thereby making the exchange rate regime a central piece of any national economic policy framework.

Types of regimes

Exchange rate regimes are typically divided into three broad categories. At one end of the spectrum are *hard exchange rate pegs*. These entail either the legally mandated use of another country's currency (also known as full dollarization) or a legal mandate that requires the central bank to keep foreign assets at least equal to local currency in circulation and bank reserves (also known as a currency board). Panama, which has long used the U.S. dollar, is an example of full dollarization, and Hong Kong SAR operates a currency board.

Hard pegs usually go hand in hand with sound fiscal and structural policies and low inflation. They tend to remain in place for a long time, thus providing a higher degree of certainty for pricing international transactions. However, the central bank in a country with a hard exchange rate peg has no independent monetary policy because it has no exchange rate to adjust and its interest rates are tied to those of the anchor-currency country.

In the middle of the spectrum are *soft exchange rate pegs*—that is, currencies that maintain a stable value against an anchor currency or a composite of currencies. The exchange rate can be pegged to the anchor within a narrow (+1 or –1 percent) or a wide (up to +30 or –30 percent) range, and, in some cases, the peg moves up or down over time—usually

depending on differences in inflation rates across countries. Costa Rica, Hungary, and China are examples of this type of peg. Although soft pegs maintain a firm “nominal anchor” (that is, a nominal price or quantity that serves as a target for monetary policy) to settle inflation expectations, they allow for a limited degree of monetary policy flexibility to deal with shocks. However, soft pegs can be vulnerable to financial crises—which can lead to a large devaluation or even abandonment of the peg—and this type of regime tends not to be long lasting.

At the other end of the spectrum are *floating exchange rate regimes*. As the name implies, the floating exchange rate is mainly market determined. In countries that allow their exchange rates to float, the central banks intervene (through purchases or sales of foreign currency in exchange for local currency) mostly to limit short-term exchange rate fluctuations. However, in a few countries (for example, New Zealand, Sweden, Iceland, the United States, and those in the euro area), the central banks almost never intervene to manage the exchange rates.

Floating regimes offer countries the advantage of maintaining an independent monetary policy. In such countries, the foreign exchange and other financial markets must be deep enough to absorb shocks without large exchange rate changes. Also, financial instruments must be available to hedge the risks posed by a fluctuating exchange rate. Almost all advanced economies have floating regimes, as do most large emerging market countries.

Common language

Because the exchange rate regime is an important part of every country's economic and monetary policy, policymakers need a common language for discussing exchange rate matters. After all, an exchange rate regime that looks soft to one observer may look hard to another—which reflects, among other things, a lack of information among different players about foreign exchange markets and about purchases or sales of foreign exchange by central banks.

The IMF has developed the most widely used language and terminology for classifying exchange rate regimes, as part of its mandate to oversee the exchange rate policies of its member countries. Historically, exchange rate regimes reported by the IMF were based on a country's own classification, that is, a *de jure* regime. But starting in 1999, the IMF also began to report *de facto*—that is, observed—exchange rate regimes based on the IMF staff's assessment of available information. And a comparison of *de jure* and *de facto* regimes shows a fair number of discrepancies (see box).

Fix or Float?

Shifting trends

Currently, on a de facto basis, 48 countries have hard pegs, 60 countries have soft pegs, and 79 countries have floating rates—a marked change from the early 1990s. Since then, there have been two broad trends in regimes. The first is the “hollowing out of the middle” that started around 1990 (see chart). At the time, capital flows around the world had accelerated in response to both the removal of capital account controls and the development of new financial products and markets. However, inflows to many countries came to a “sudden stop,” typically in the context of a rising current account deficit, and led to a fall in the demand for their currencies. In some cases—particularly in Western Europe in 1992 and in East Asia during the late 1990s—the demand fell so dramatically that countries ran out of international reserves for defending the peg and were forced to devalue their currencies. In most cases, they moved to either a hard peg exchange rate, which is resilient to inflows, or to a float, which precludes the need to commit to a level of the exchange rate.

This “hollowing out of the middle” came to a halt in 2001. The period since then has seen a more subtle shift in countries’ exchange rate regime choices. Within the floating group, more countries are now managing the exchange rate rather than floating independently, and soft pegs have also regained

Are appearances everything?

For more than a decade, countries have been trying to appear to be running a more flexible exchange rate regime than they actually are—a trend that is increasingly coming to light in the IMF’s exchange rate regime classification system, which reports both de facto and de jure regimes for all member countries. Take the following examples.

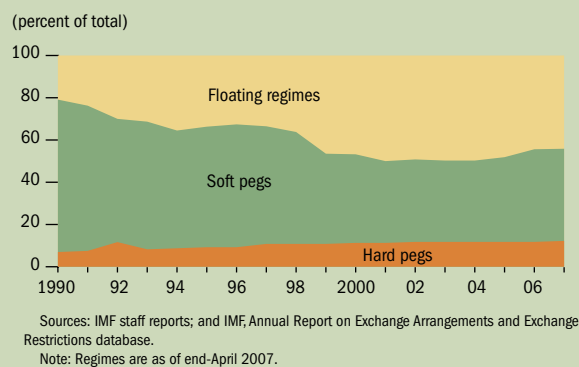
- In the “hollowing out” years of the late 1990s, a number of countries reported themselves as floating, but they were classified in de facto terms as pegged. Subsequently, a number of them were compelled to exit to de facto floating regimes under market pressure.

- These days, 25 countries report that they are running a flexible arrangement, although they have a de facto conventional peg. Another 14 countries report themselves as operating an independent float, although they have a de facto managed float.

What’s behind the discrepancy between what is said and what is done? It probably reflects the desire of countries to be perceived as market friendly, as well as a reluctance to be seen as committed to a particular level of the exchange rate.

Shifting choices

The move from soft pegs to floating or hard peg regimes in the 1990s was followed by more subtle shifts after 2001.



some of their earlier popularity. Many countries are not able or willing to commit to a hard peg, but neither are they able to float freely because of gaps in financial markets and because exchange rate changes can seriously affect countries’ balance sheets, inflation, and growth. Moreover, in a number of cases, the de facto shift toward more tightly managed regimes has occurred without a declared (de jure) change in exchange rate policies.

What the future holds

What can be expected of exchange rate regimes in the future? One school holds that the benefits of currency blocs—groups of countries using a single currency (probably the U.S. dollar, the yen, or the euro)—are so overwhelming that the number of independent currencies will inevitably dwindle, perhaps to the single digits. This would simplify cross-country transactions but preclude each country in a bloc from operating an independent monetary and exchange rate policy.

Another school stresses the benefits of a floating exchange rate and independent monetary policy and predicts the continued existence of a large number of national currencies tethered to various nominal anchors. Whether a large number of floating exchange rate currencies remain, or whether they coalesce into a small number of bloc currencies, will have very different implications for businesses, policymakers, and owners of surfboard shops. ■

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