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Exchange rate regime choice and currency crises

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A B S T R A C T

Exchange rate regime choice is not exogenous, but it depends on the structural, political and financial features of countries. However, it is often the case that the regime actually pursued and the one that is imposed by country features do not match one to one. The existing empirical crisis models do not take fully into account the regime in which the crisis unfolded. The aim of this paper is to incorporate the *appropriateness* of the regime choice into the standard currency crisis model. The results show that the odds of crisis increase significantly in countries which have chosen regimes inconsistently.

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1. Introduction

This paper aims to fill the gap between the exchange rate regime choice (ERRC) and currency crisis (CC) literatures by bringing the question of *appropriateness* of the regime to the forefront in analyzing the currency crisis. The exchange rate regime can be viewed as a stage on which real and nominal shocks interact with macroeconomic policies conducted by the authorities. As indicated by the ERRC literature, exchange rate regime choice is not exogenous, but depends on the structural, political and financial features of countries. However, it is often the case that the regime actually pursued and the one that is imposed by country features may not match one to one. There are obvious reasons; using pegged regimes to tame inflationary expectations has been a widely adopted policy in high inflation countries.[1] This is not costless, however. The trade-off between the sustainability of the regime and the desire for macroeconomic stability often resulted in missing both targets as currency crises

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[1] See von Hagen and Zhou (2005) for the discussion of the determinants of regime discrepancies.

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episodes in the last couple of decades clearly indicate. Yet, the existing empirical literature on currency crisis, by and large, does not take into account this point, namely the question of appropriateness of the ongoing regime within which the crisis is unfolded. The implicit assumption that the occurrence of a currency crisis is independent of the regime choice is a very strong one, and one which carries the potential to bias estimation results.

As Frankel (1999) puts it, "the choice of exchange rate arrangement should depend on the particular circumstances facing the country in question". From the sustainability point of view, the immediate question that may follow this statement is what happens if the regime that has been chosen does not match those "particular circumstances". Does this discrepancy provide a fertile ground for vulnerabilities to grow, or not? Or, put differently, do real, nominal or policy shocks affect countries in the same direction regardless of the regimes at work?

The most common reason behind choosing a regime other than what is optimal is the desire for macroeconomic stability. Especially following the collapse of Bretton Woods in the mid-1970s, countries started to use exchange rate regimes as a tool to stabilize their economies. In the so-called exchange-rate-based stabilization (ERBS) programs, exchange rates represent the nominal anchor for stabilizing chronic high inflation. However, these programs are heavily criticized on the grounds that they led to excess volatility in the domestic economy, see Calvo and Vegh (1999), Tornell and Westermann (2002), Hamann et al. (2005) and Ranciere et al. (2005). For example, less-than-perfectly credible exchange rate stabilization programs may trigger a consumption boom as agents increase their demand for consumption or investment goods when these are "cheap", in other words, before the eventual collapse of the currency. The studies mentioned above clearly show that an "inappropriate" choice of regime (a choice that is inconsistent with the structural, political and financial features of the country) is not costless. And this is exactly the juncture where this study kicks in.

To our knowledge, this paper is the first study investigating the question of regime appropriateness in the context of currency crises. The line of reasoning is that different country characteristics require different regimes and unless the regimes are consistent with those characteristics, countries gradually become more vulnerable to adverse shocks which may lead them to crisis.

In the paper we will use the IMF's *de facto* regime classification.[2] The sample consists of 163 developed and developing countries and covers the period between 1990 and 2007.

The outline of the paper is as follows: in the coming section we will review the relevant studies in ERRC and CC literatures and discuss the link between regime choice and currency crises. In the methodology part, we will describe the important steps of our analysis. After discussing the regression results, in Section 4 we will conduct a battery of robustness checks to test the validity of our results. In the final part we will conclude.

2. Literature review

This study aims to fill the gap between the CC and ERRC literatures by incorporating the question of *appropriateness* of the regime choice into the standard early-warning crisis models.

The interest in currency crisis took a fresh start following the collapse of the Bretton Woods system in the mid-1970s. In the absence of a properly functioning and universally accepted international monetary system, many countries/regions are faced with a dilemma between macroeconomic and exchange rate stability.

In the theoretical crisis models, the representative country is often assumed to be pursuing a fixed regime. This is not accidental; on the contrary, in these models the regime choice plays a pivotal role. In the first-generation models[3] the root cause of the crisis is the inconsistency between the monetary policy and the exchange rate regime. The so-called "impossible trinity" argument states that in a country where capital flows freely, countries having a pegged regime and independent monetary

[2] Note that this classification is not based on the official announcement of the regime by the authorities (*de jure*) but is constructed with consultation of the IMF country desk officials. In other words, it is *de facto* as the Reinhart and Rogoff (2004) and Levy-Yeyati and Sturzenegger (2005) classifications.

[3] See Krugman (1979) and Flood and Garber (1984).

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