Journal of Development Economics 107 (2014) 244–261

Contents lists available at ScienceDirect

Journal of Development Economics

journal homepage: www.elsevier.com/locate/devec

Mark my words: Information and the fear of declaring an exchange rate regime

Pierre-Guillaume Méon [a,*], Geoffrey Minne [b,1]

[a] Université libre de Bruxelles (ULB), Centre Emile Bernheim, Avenue F.D. Roosevelt, 50, 1050, Brussels CP-114/03, Belgium
[b] Université libre de Bruxelles (ULB), Centre Emile Bernheim and ECARES, Avenue F.D. Roosevelt, 50, 1050 , Brussels CP-139, Belgium

ARTICLE INFO

Article history:
Received 5 December 2011
Received in revised form 6 November 2013
Accepted 12 December 2013

JEL classifications:
F33
F41
F53
F59
L82

Keywords:
Official exchange rate regime
De facto exchange rate regime
Press freedom
Information
Fear of floating

ABSTRACT

This paper investigates the role of a free press and the circulation of information on the capacity of a country to declare an exchange regime that differs from the regime it implements *de facto*. We report consistent evidence that greater press freedom and easier access to information result in a lower probability of untruthfully reporting the *de facto* regime. These findings withstand a large set of robustness checks, including controlling for democracy and for the institutional and political environment, controlling for endogeneity, and using various estimation methods. The results are particularly strong for developing countries.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

Exchange rate practices are a field in which words and deeds often fail to coincide. On the one hand, countries that officially peg their exchange rate may frequently adjust the parity of their currency (Ghosh et al., 1997). As a consequence, their exchange rate policy shares common features with a flexible exchange rate regime. On the other hand, countries that officially let their currency float may intervene to stabilize it, displaying what Calvo and Reinhart (2002) refer to as the "fear of floating". The discrepancies observed between announced and implemented policies led to the development of *de facto* classifications of exchange rate regimes, for instance by Reinhart and Rogoff (2004), Levy Yeyati and Sturzenegger (2005), or Shambaugh (2004). *De facto* classifications reveal that exchange rate practices are often quite different from official *de jure* exchange rate regimes, and call into question the meaningfulness of *de jure* regimes in the study of exchange rate regimes. The propensity to declare and implement different exchange rate regimes is particularly strong among developing countries, as Frankel et al. (2001), Calvo and Reinhart (2002), or von Hagen and Zhou (2009) report.

The positive literature on the choice of an exchange rate regime quickly took stock of those findings. Studies of the determinants or consequences of the choice of an exchange rate regime, such as Masson (2001) or Klein and Shambaugh (2008), have therefore replaced *de jure* regimes by *de facto* ones. Another strand of research tries to explain the observed fear of floating. This fear has thus been related to the risk of balance sheet losses in a devaluation in the presence of unhedged debt denominated in foreign currency (Hausmann et al., 2001), to the risk of speculative currency crises (Obstfeld and Rogoff, 1995), or to the consequences of an appreciation, be it for prudential motives (Aizenman and Sun, 2012) or mercantilist motives (Levy Yeyati et al., 2013).

The aforementioned studies explain why some countries are reluctant to let their exchange rate float freely, or to announce a highly visible exchange rate target, but they do not explain why those countries implement one regime and declare another. For this, it is necessary to specifically study the gap between the observed and declared regimes, as opposed to the chosen regime. A handful of papers have addressed that question. Alesina and Wagner (2006) underline the impact of the quality of institutions. Their empirical study suggests that good political institutions drive policymakers to deviate from flexible to more rigid regimes, whereas bad institutions cause policymakers to deviate

* Corresponding author. Tel.: +32 2 650 65 99.
E-mail addresses: pgmeon@ulb.ac.be (P.-G. Méon), gminne@ulb.ac.be (G. Minne).
[1] Tel.: +32 2 650 42 97.

0304-3878/$ – see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jdeveco.2013.12.005

from fixed to more flexible regimes. Carmignani et al. (2008) add social and political issue to institutional issues as explanatory variables. They show that governments that are subject to an adverse political environment find it harder to sustain the commitment to a peg, and governments facing social instability are more likely to opt for fear of floating behavior. Von Hagen and Zhou (2005) find that the probability of observing a discrepancy between the *de facto* and *de jure* regimes in transition countries increases when the *de jure* solution is inappropriate. Finally, von Hagen and Zhou (2009) argue that the governments of developing countries display fear of floating to avoid the political costs of exchange rate crises while nevertheless stabilizing exchange rates.

The common feature of these papers is that they all focus on the motives for a country to declare a *de jure* regime that differs from its *de facto* regime, but overlook the constraints that may limit its scope for doing so. The aim of this paper is precisely to investigate one such constraint. More specifically, we investigate the extent to which press freedom and easy access to information constrain a country's declaration of its exchange rate regime.

This is important because there is strong evidence that the media influence the conduct of monetary policy. Havrilesky (1995), Maier et al. (2002), or Maier and Bezoen (2004), for instance, document that major central banks respond to media pressure. However, whether or not the exchange rate policy is affected by the press remains an unaddressed question. Moreover, a vast literature has investigated the relationship between democracy and the transparency of the political system and exchange rate policy (see Bernhard and Leblang, 1999, or Broz, 2002), but the determinants of the truthfulness of a country's declaration have been overlooked. Finally, the question is of particular relevance to developing countries, where the exchange rate regime remains a key policy decision that is not easily observable by private agents, as Frankel et al. (2001) have shown, while major differences in terms of press freedom are observed among those countries (see Brunetti and Weder, 2003).

From a theoretical point of view, the effect of press freedom and access to information on the propensity to dissimulate the exchange rate regime is in principle uncertain. On the one hand, if the media essentially seeks to detect and reveal the misreporting of the exchange rate regime, increasing press freedom and access to information would reduce the propensity of policymakers to declare a regime that differs from the actual one. The media would then act as a "watchdog". On the other hand, if the main role of the media is to transmit the pressure arising from opponents, interest groups and politicians to policymakers, then increasing press freedom and access to information will increase the policymakers' propensity to declare a regime that differs from the actual one. The media would then essentially be a "means of pressure".

Which view prevails is an empirical issue. Consequently, we test the two views by estimating a series of models in which the dependent variable is the difference between the *de facto* and *de jure* exchange rate regimes, using a panel dataset containing both developed and developing countries. Our contribution to the literature is manifold. First, we extend the debate about the fear of declaring an exchange rate regime by introducing the role of information as a constraint on policymakers. We thus extend Alesina and Wagner's (2006) initial findings. Second, we contribute to the literature on the role of democracy and transparency of the political system in exchange rate policy (see Bernhard and Leblang, 1999, or Broz, 2002). Finally, the study addresses the relation between the media and monetary policy (see Berger et al., 2011; Maier and Bezoen, 2004; Maier et al., 2002).

We report consistent evidence supporting the watchdog view of the media. Specifically, we find that greater press freedom, measured by several subjective and objective indices, and easier access to information, measured by the percentage of Internet users, daily newspaper circulation and mobile phone subscriptions, result in a lower probability of untruthfully reporting the *de facto* exchange rate regime. Those findings withstand a large set of robustness checks, including controlling for democracy and the quality of institutions, using different classifications of the *de facto* exchange rate regime, controlling for endogeneity, and using various estimation methods. Moreover, we find that the results are particularly strong for developing countries.

With these goals in mind, the rest of the paper is organized as follows. Section 2 discusses in more detail the motivations to untruthfully report the exchange rate regime and the theoretical impact of press freedom and access to information on the propensity to do so. Section 3 describes our empirical strategy. Section 4 displays our findings, while Section 5 tests their robustness. Section 6 concludes.

2. Media and exchange rate regime practices: watchdog vs. means of pressure

There are many reasons for a country's policymakers to wish to implement a given exchange rate regime and declare another. We survey those reasons in the next subsection. Provided policymakers wish to conceal their true exchange rate regime, the relation between press freedom and their capacity to do so is ambiguous in principle. It will differ depending on the media play the role of a watchdog or act as means of pressure. These issues are discussed in two specific subsections.

2.1. The incentives to conceal the true exchange rate regime

The reasons for policymakers to actively manage the exchange rate while formally declaring that it floats have been discussed at length in the literature devoted to the fear of floating. Genberg and Swoboda (2005) argue that announcing a *de jure* fixed exchange rate regime is risky because it gives speculators the possibility to launch speculative attacks against the announced parity. Therefore, policymakers wishing to stabilize their exchange rate have an incentive to declare that they let their currency float. This makes it harder for speculators to attack a target parity that they do not know, and to which policymakers have not committed.

Whereas announcing a floating regime is less costly in terms of commitment, the benefits of not implementing it may be substantial. The most straightforward motivation for actively managing the exchange rate is to preserve or increase the country's real competitiveness, according to what Levy Yeyati et al. (2013) deem a "mercantilist motive". Policymakers willing to boost exports may thus intervene either to prevent the currency from appreciating or to keep it undervalued. Such policies may be the outcome of the political pressures of firms operating in the tradable sectors, as Frieden (1991) argues and Broz et al. (2008) document.

Preventing adverse balance-sheet effects due to currency mismatch is another reason for avoiding substantial depreciations. If the country's debt is denominated in foreign currency, exchange rate depreciation will increase the country's debt burden in local currency, threatening the sustainability of the public debt and leading to bankruptcies in the private sector. In accordance with that argument, Hausmann et al. (2001) report evidence that the authorities of countries that cannot issue debt in their own currency, a group that includes many developing countries, are more likely to actively stabilize their floating exchange rate.

Policymakers may be concerned about the volatility of the exchange rate as well as about its level. Calvo and Reinhart (2002) suggest that such behavior can also be explained by the tendency, particularly among developing and emerging economies, to couple a floating exchange rate and inflation targeting when the pass-through of exchange rate movements to prices is large. Targeting the inflation rate therefore implies cushioning exchange rate movements, even though the exchange rate does not directly enter the policymakers' objective function. The explanation is particularly relevant to developing countries, because, as Calvo and Reinhart (2000) document, exchange rate volatility is harmful to trade and its pass-through to inflation is large in those countries. Frieden (1991) remarks that policymakers may aim to smooth exchange rate movements as a reaction to pressure from stakeholders in the tradable sector, which is directly exposed to exchange rate movements. In

Download English Version:

https://daneshyari.com/en/article/5094654

Download Persian Version:

https://daneshyari.com/article/5094654

Daneshyari.com