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International monetary arrangements for the 21st century—Which way?

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ABSTRACT

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This paper examines some competing views on currency regime choice by applying the dynamic multi-state Markov (MSM) model to the regime transitions of 166 countries from 1980 to 1999. The findings suggest that the bipolar view is valid only in the long run and for a reason quite different from what the proponents had imagined, namely, economic development rather than crisis-driven exits. The estimated steady-state probabilities even predict that a unipolar fixed exchange rate system could emerge in the long run. Despite some divergence, both *de jure* and *de facto* regime data corroborate the key findings. *J. Japanese Int. Economies* **25** (2) (2011) 47–63. Bangladesh Institute of Development Studies, E-17 Agargaon, Sher-e-Bangla Nagar, Dhaka 1207, Bangladesh.

1. Introduction

> "…contingent policy rules to hit explicit exchange rate targets will no longer be viable in the 21st century…[C]ountries…will be forced to choose between floating exchange rates on the one hand and monetary unification on the other." Eichengreen (1994), pp. 4–5.

Eichengreen (1994) and others predict that international monetary arrangements will take a bipolar shape in the 21st century. They argue that greater exposure to global capital markets makes intermediate exchange rate regimes such as adjustable peg, crawling peg and crawling band susceptible to

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speculative attacks. Therefore, countries will be forced to move to the corners, either to a fixed regime such as currency union, currency board or dollarization, or to a freely floating regime (Eichengreen, 1994; Obstfeld and Kenneth, 1995; Summers, 2000). The bipolar view, which became popular in the 1990s, considers that all exchange rate regimes except completely fixed and freely floating regimes as unsustainable.[1] The bipolar view appears to be largely consistent with the *impossible trinity doctrine*.[2]

The proponents of the bipolar view claim that an intermediate regime will be hollowed out over time as a result of involuntary transitions, particularly for a crisis.[3] The view was rapidly adopted by the financial establishments as the "new conventional wisdom" (Frankel, 2003) after the Asian crisis in 1997–1998 with a view to "reform financial architecture" so as to minimize the frequency and severity of crises in the future. This paper, therefore, aims to examine the validity of this view of exchange rate regime choice in a thorough empirical investigation.

Do crises lead to the disappearance of the intermediate regime? Even though the proponents of the bipolar view argue that crises produce an irreversible transition toward the poles, various case studies show that transitions occur not just away from an intermediate regime, but also toward it. Some transitions are hastily executed and some are highly deliberated, with or without the occurrence of crises. For example, a number of Asian countries adopted floating regimes during the time of crisis in 1997–1998, but they reverted to a *de facto* intermediate regime after the crisis. Thailand and Korea are notable examples (Hernandez and Peter, 2003). On the other hand, the currency union was adopted voluntarily by European countries in 1999 with preceding preparations done in steps, such as the Exchange Rate Mechanism (ERM) of the European Monetary System, and its predecessor, the Snake.

Therefore, both voluntary and involuntary transitions can happen toward the poles, which seem contradictory with the claim of the proponents of the bipolar view. It is therefore asked in this paper, is the bipolar view likely to be valid for crises, as mentioned by the proponents, or could it be valid for different reasons? To answer this question, the dynamics of currency regime transitions of 166 countries are studied for the period 1980–1999 using both *de jure* and *de facto* data.[4]

The paper examines whether the distribution of exchange rate regimes tends to converge to the polar extremes and identify factors that increase the likelihood of convergence. To this end, combined with transition intensities involving determinants of regime transitions under the multi-state Markov (MSM) model, this paper sets a testable approach as follows. *If the rates of transition from intermediate regimes to the poles are higher than the rates of reverse transition, and if capital integration and currency crises facilitate transition, it would suggest that the bipolar view is likely to be valid*. Although this approach points to a weaker definition of the bipolar view as it allows some transitions toward the intermediate regime, it is helpful in exploring a broader scope of the view.

Two recent studies provide evidence against the bipolar view. Masson (2001) is the first study which casts a light on the hollowing out hypothesis directly and shows that there are non-zero transition probabilities to intermediate regimes, implying that the bipolar view is not correct strictly. However, it did not study the causes. In another study, Masson and Ruge-Murcia (2005) endogenize the exchange rate regime transitions to show that inflation and, to a lesser extent, output growth and trade openness can explain regime transitions, but not necessarily toward the bipolar direction.

Although significant contributions, it is not clear from these studies whether the view may gain some validity from a long run perspective and for the reasons mentioned by its proponents, the main one being crises. Our analysis departs from the above studies in two important ways. First, while the strict definition of the view (i.e. no transition toward intermediate regime) is not supported by data (Masson, 2001), this study proposes an alternative test involving a weaker definition of the view by

[1] This view is variously called, "the corners hypothesis", "the two poles view", "hollowing out hypothesis" and "the vanishing middle".

[2] This doctrine states that a country must give up one of the three goals: exchange rate stability, monetary independence and financial market integration, that is, a country cannot have all three simultaneously.

[3] As in the currency crisis models, an abandonment of an intermediate regime (pegs) happens when countries with intermediate regime experience excessive domestic credit growth, overvalued exchange rates, or weak economic growth and high unemployment.

[4] Not all countries' regimes are available for all dates.