Exchange Rate Regimes: Is the Bipolar View Correct?

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Exchange rate regimes have shifted toward a bipolar distribution during the past decade. Both "hard" pegs and floating regimes not committed to a particular exchange rate are gaining at the expense of "soft" pegs, in which the central bank is committed to a specific range or allows the exchange rate band to move over time. This trend holds true not only for countries active in international capital markets but for all countries. With soft pegs being crisis prone in an environment of open capital markets, the development toward increasingly bipolar exchange rate regimes will persist.

Each of the major international crises since 1994—Mexico in 1994; Thailand, Indonesia, and Korea in 1997; and Russia and Brazil in 1998—has in some way involved soft-pegged exchange rate regimes. Countries that did not have soft-pegged rates avoided these crises. With policymakers warning against the use of adjustable peg or other soft-pegged exchange rate regimes for countries open to international flows, countries are increasingly choosing to peg their currencies hard (as in a currency board) or allowing their currencies to float freely.

International Monetary Fund (IMF) data for exchange rate regimes from more than 150 countries show a marked shift in the 1991–99 period. Countries are shifting from soft pegs—such as crawling pegs and commitments to keep exchange rates within specific ranges—toward hard pegs and free floating currencies. In 1999, 66 percent of exchange rate regimes were classified as hard pegs or floating, up from 39 percent in 1991.

The major explanation for the nonviability of soft pegs for a country open to international capital flows is that they are an attempt to have

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both a fixed exchange rate and a monetary policy directed at domestic goals. Sooner or later, an irreconcilable conflict arises between these goals. These conflicts became apparent in the 1990s as a result of the growing openness of capital accounts and increasing private-sector capital flows toward emerging markets.

Interest rate adjustments are effective for addressing a relatively small disequilibrium, but when a disequilibrium becomes large, policymakers—either for political reasons or because of concerns of damage to the domestic economy—are reluctant to implement the requisite increases in interest rates. Capital controls can help a country sustain a soft-pegged exchange rate regime, but as the Chilean experience indicates, capital controls seem to lose their effectiveness over time. Moreover, as economies mature, they will invariably want to liberalize their capital accounts and integrate into global capital markets.

A country's choice between a hard peg and floating rate depends in part on the characteristics of the economy and its inflationary history. A hard peg makes sense for a country with a long history of monetary instability and/or for a country closely integrated in both its capital and current account transactions with another economy or a group of other economies. Floating rates may be desirable for countries with one or more of the following characteristics: a historical tradition of monetary stability, no obvious subset of other countries with which to form a monetary union, and a belief that a flexible exchange rate will help the economy adjust to macroeconomic shocks.

Over the medium term, the recent trend of shifting more toward the floating than to the hard end of the exchange rate spectrum is expected to persist. In the longer term, however, and depending on how well the euro area and dollarized economies operate, the trend could well be to move from the floating to the hard peg end of the spectrum.

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