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Exchange Rate Regimes and the Stability of the International Monetary System

Atish R. Ghosh, Jonathan D. Ostry, and Charalambos Tsangarides

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Preface

The member countries of the International Monetary Fund (IMF) undertake to collaborate with each other and the IMF to assure orderly exchange arrangements and promote a stable system of exchange rates, recognizing that the essential purpose of the international monetary system is to facilitate the exchange of goods, services, and capital among countries, and to sustain sound economic growth. This Occasional Paper, requested by Executive Directors during their discussion of the Independent Evaluation Office (IEO) report on IMF exchange rate policy advice (IEO, 2007), reviews the stability of the overall system of exchange rates by examining macroeconomic performance (inflation, growth, crises) under alternative exchange rate regimes; implications of exchange rate regime choice for interaction with the rest of the system (external adjustment, trade integration, capital flows); and potential sources of stress to the international monetary system.

The paper was prepared under the direction of Jonathan D. Ostry, Deputy Director, Research Department, by a staff team led by Atish R. Ghosh, Chief, Systemic Issues Division, and comprising Marcos Chamon, Chris Crowe, Julian di Giovanni, Jun Kim, Marco Terrones, and Charalambos Tsangarides. The authors are grateful to Mary Yang and Maria Victoria Fazio for research assistance, and to Sheila Tomilloso for administrative assistance. David Einhorn of the External Relations Department, and Mahvash S. Qureshi of the Research Department, coordinated the production and publication of the paper.

An earlier draft of the paper was presented to the IMF's Executive Board at an informal seminar, and the current version has benefited from the comments made by Executive Directors on that occasion. The opinions expressed in the paper are those of the authors, however, and do not necessarily reflect the views of the national authorities, the International Monetary Fund, or IMF Executive Directors.

Overview 1

This paper reviews the stability of the overall system of exchange rates along three dimensions: Do individual countries' choice of exchange rate regime help them achieve their domestic macroeconomic goals? Does this choice of regime facilitate the country's interaction with the rest of the system? And is the system as a whole stable? Previous studies undertaken on this issue (Mussa and others, 2000; Rogoff and others, 2004) tackled one or another of these aspects; however, this paper is the first to analyze all three together.

Mussa and others (2000) argued in favor of a bipolar view of exchange rate regimes—advocating hard pegs or free floats, and eschewing intermediate regimes. Rogoff and others (2004) were even clearer in their advocacy of flexible regimes, particularly for emerging market economies (EMEs). This paper's comprehensive empirical analysis delivers a more nuanced message. On the one hand, pegged regimes provide a useful nominal anchor without compromising growth, and intermediate regimes are also associated with low nominal volatility and higher economic growth, especially for EMEs; both intermediate and pegged regimes are also associated with deeper trade integration, which is growth-enhancing. On the other hand, floating regimes are associated with smoother external adjustment and lower susceptibility to financial crises.

Turning to systemic issues, the paper identifies three related potential sources of instability. First, the recent crisis could heighten EMEs' incentives to self-insure via reserves accumulation. This could create pressures for competitive depreciations, exacerbate global imbalances, and—if accumulated against persistent U.S. deficits—ultimately undermine confidence in the reserve currency status of the dollar. Greater access to IMF resources, including precautionary instruments, or to a synthetic reserve asset (such as the Special Drawing Right) could help prevent this outcome. Second, because external imbalances are more persistent under less flexible exchange rate regimes, greater exchange rate flexibility in key surplus countries, together with the full range of supporting policies envisaged in the IMF-sponsored Multilateral Consultations for other countries (IMF, 2007), would tend to reduce systemic risks. Finally, continued U.S. deficits over the long term could eventually undermine confidence in the dollar's reserve currency status. Although a sudden and destabilizing stock adjustment in reserves composition seems unlikely, appropriate exit policies from the crisis that credibly narrow future deficits would provide additional confidence in the dollar's reserve currency status.

For nonsystemically important countries, the choice of exchange rate regime can be tailored to their particular economic challenges, with the proviso that those opting for less flexible regimes should ensure strong macroeconomic fundamentals to minimize the risk of (potentially contagious) crises. Systemic countries should also factor in the potential for their choice to moderate or exacerbate destabilizing global imbalances. Finally, the IMF itself can contribute to the stability of the system by providing enhanced mechanisms to meet the evident underlying demand for country insurance.