2 Exchange Rate Regimes and International Monetary Systems

One must have knowledge in foreign exchange rate regimes and foreign exchange rate arrangements to better understand foreign exchange rate behaviour, since the choice of foreign exchange rate regimes can influence or determine how the exchange rate between two currencies moves and fluctuates on foreign exchange markets. For example, if an arrangement is made for a currency which fixes the currency’s exchange rate against the US dollar, then there is little sense to study the market force for the sake of exchange rate determination for the currency.

This chapter examines various foreign exchange regimes in international monetary systems and discusses their features. A brief review of the history of international monetary systems is also provided in the chapter, since the past lessons from the international monetary history can be helpful to the foreign exchange rate regime decision, the implementation of foreign exchange policies and the attainment of policy objectives.

2.1 Exchange Rate Regimes

The exchange rate can be totally flexible or completely free to float on the foreign exchange market on the one hand, and fixed or pegged to one of the major currencies or a basket of currencies on the other hand. Between these two extremes, there can be a few types of exchange rate arrangements and combinations. The International Monetary Fund (IMF) has classified the prevailing exchange rate regimes into eight categories. They are: Exchange Arrangements with No Separate Legal Tender, Currency Board Arrangements, Conventional Fixed Peg Arrangements, Pegged Exchange Rates within Horizontal Bands, Crawling Pegs, Exchange Rates within Crawling Bands, Managed Floating with No Predetermined Path for the Exchange Rate, and Independent Floating.

This classification system ranks exchange rate regimes on the basis of the degree of flexibility of the arrangement or a formal or informal commitment to a given exchange rate path. The classification emphasises the implications of the choice of exchange rate regimes to the independence of monetary policy. However, it must be stressed that absolute independence of monetary policy from ex-
change rate policy does not exist under any exchange rate regimes. Monetary policy decisions are taken in conjunction with a country’s external positions one way or another, with or without explicitly imposed foreign exchange rate policy constraints. Table 2.1 presents information regarding exchange rate arrangements of IMF member countries or regions. It is based on members’ actual, de facto regimes, as classified by the IMF as of April 30, 2003, which may differ from their officially announced arrangements.

Under independent floating, the exchange rate is market determined. The regime is also called free floating or clean floating. Foreign exchange intervention, if any, does not aim at establishing a level for the exchange rate; rather, it aims at moderating the rate of change and preventing undue fluctuations in the exchange rate. Monetary policy is, in principle, independent of exchange rate policy with an independent floating exchange rate regime.

Managed floating that is sometimes called dirty floating, or managed floating with no predetermined path for the exchange rate in full, has a lower degree of flexibility, compared with independent floating. The monetary authority influences exchange rate movements through active, direct or indirect intervention to counter the long-term trend of the exchange rate without specifying a predetermined exchange rate path or without having a specific exchange rate target. Indicators for managing the exchange rate are broadly judgmental, e.g., through balance of payments positions, international reserves, parallel market developments, and adjustments may not be automatic.

The IMF distinguishes “tightly managed floating” where intervention takes the form of very tight monitoring that generally results in a stable exchange rate without having a clear exchange rate path from “other managed floating” where the exchange rate is influenced in a more ad hoc fashion. The former intervenes with the aim of permitting authorities an extra degree of flexibility in deciding the tactics to achieve a desired path, while the latter lacks such an aim in managing the exchange rate.

Under the arrangement of exchange rates within crawling bands, the currency is maintained within certain fluctuation margins of at least ±1% around a central rate, which is adjusted periodically at a fixed rate or in response to changes in selective quantitative indicators. The degree of flexibility of the exchange rate is a function of the band width. Bands can be either symmetric around the crawling central rate or asymmetric with different upper and lower bands. The commitment to maintaining the exchange rate within the band imposes constraints on monetary policy, the narrower the band, the lower degree of independence monetary policy possesses.

Conventional fixed peg arrangements are exchange rate regimes where a country formally or de facto pegs its currency at a fixed rate to another currency or a basket of currencies, where the basket is formed from the currencies of major trading or financial partners and weights reflect the geographical distribution of trade, services, or capital flows, or the SDR. The monetary authority can adjust the level of the exchange rate, although relatively infrequently. There is no commitment to keep the parity irrevocably. The exchange rate may fluctuate within a narrow