1. Objective and analytical foundation

Exchange rate regimes can be represented on a spectrum that constitutes hard pegs (currency union, dollarization, currency board), conventional fixed peg, intermediate regimes (band, basket peg, and crawling peg), managed floating, and independent floating according to the degree of fixity of exchange rates.

Some developing countries have experienced major changes in their exchange rate regimes since the 1990s. Argentina adopted a currency board (1991–2002). Some Baltic and Eastern European countries also adopted currency boards in the 1990s. East Asian and Latin American countries experienced currency crises after which they moved to floating exchange rate regimes. Ecuador dollarized in 2000. On the other hand, based on rapid integration in trade and finance, a concern for monetary integration in East Asia is rising. We term changes of exchange rate regimes in developing countries as represented above as new developments. Our objective in this book is to present theoretical and empirical analyses of the new developments since the 1990s. Because this book addresses a variety of exchange rate regimes from hard peg to floating, and various regions of East Asia, Latin America, and Eastern Europe, we can observe diverse cases of how various exchange rate regimes relate to the national economy in developing countries.

In analyzing diverse experiences under a variety of exchange rate regimes in developing countries, we base our arguments on the following analytical framework. In an environment under which finance and trade are fully integrated, an economy which adopts a fixed exchange rate regime must have monetary policy autonomy largely restricted. This economy must bear the cost of restricted monetary policy autonomy, and must lose the means of correcting current account imbalance by exchange rate changes. On the other hand, an economy with a flexible exchange rate regime would have monetary policy autonomy and have the means to correct current account imbalance. Thus, the effect of a choice of exchange rate regimes on a national economy crucially depends upon how important money affects real production, and how important...
exchange rate flexibility is in the adjustment of current account balance. These two criteria on the effect of a choice of exchange rate regime on a national economy can be applied to the discussion of an optimum currency area, a domain under which a common monetary policy bears few costs.

The relationship between an exchange rate regime and a national economy is multifaceted; the exchange rate regime relates to a national economy through the structural characteristics of an economy, namely monetary and fiscal policies, external trade, the degree of foreign currency denomination of external debts, foreign indebtedness, nominal wage rigidity, productivities and the structures of industries, etc. Moreover, a national economy is subject to real or nominal shocks, originating both inside and outside of its national borders.

These structural characteristics and shocks affect a national economy through the exchange rate regime. The causality does not run in one direction; the structural characteristics and shocks, in turn, affect the choice of exchange rate regimes in developing countries.

Thus, in our studies of exchange rate regimes, we focused on structural characteristics and the nature and the degree of shocks in developing countries; how they affect a national economy through the exchange rate regimes and how they affect choices of the regimes. In what follows, based on the analytical foundation explained above, we show in each chapter the relationship of structural characteristics and/or shocks to the choice of exchange rate regimes in developing countries.

One structural characteristic of developing countries is the difficulty in borrowing in terms of their own currencies, which was pointed out by Eichengreen and Hausmann (1999). As a result, currency mismatches on the balance sheet, where liabilities denominated in foreign currencies outweigh assets denominated in domestic currencies on balance sheets, occur. In order to avoid the large amplitude of business cycles caused by net worth changes due to exchange rate fluctuations, exchange rate fluctuations in emerging market countries are kept smaller than expected under the flexible exchange rate regimes. This phenomenon was called “fear of floating” by Calvo and Reinhart (2002). Chapter 1 presents econometric evidence of this argument.

East Asian exchange rate regimes before the currency crisis are often characterized as a dollar peg. Under this assumption, McKinnon and Schnabl (2003) argue that a nominal shock of yen/dollar fluctuations has been a major determinant for East Asian business cycles. Instead, Chapter 4 argues that the real shock of global demand cycles for electronic goods has been more important than the nominal shock of yen/dollar fluctuations for East Asian business cycles. Furthermore, most East Asian countries’ exchange rate regimes were not a simple dollar peg. Rather, East Asian exchange rate policies were more pragmatic than commonly thought; they may have monitored the effective value of their currencies.

Many developing countries adopted an inflation targeting regime after moving to a flexible exchange rate regime. Inflation targeting is a monetary policy