THE CHOICE OF EXCHANGE REGIMES BY TRANSITION COUNTRIES

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A question to which the economists answered many times was: Which is the exchange rate regimen adequate for an economy? Ancient literature, grounded on the works about the optimal monetary areas[1], emphasized the *economic bases* regarding the ability of a country to defeat through the demand shocks and the use of monetary policy for the management of the aggregate country. Other authors, who were interested in the analysis of the instruments of monetary policy, concentrated upon the *type and source of the dominant shocks to which an economy is exposed*.[2] The literature of the 80's developed the idea according to which the stable exchange rates might aid to import the credibility of low inflation policies from a foreign central bank[3], a specific justification for France and Italy in the European Monetary System. Recent literature notes the fact that the monetary crises of the 90's (Mexico, South-East Asia, Russia, Brasil and Argentina) involved combinations of controlling the exchange rates with the high mobility of the stocks. Therefore, one may conclude, on the grounds of the theoretical approaches, that the countries exposed to high stock flows should avoid the instable exchange rate regimes and they have at their disposal two solutions: the control of a very difficult currency (for instance a monetary council or the high exchange rate of the dollar) or flexible exchange rates, a point of view which was considered a ”worthless” hypothesis.

The Collapse of the Bretton-Woods System of the 70's offered the possibility of choosing from the various exchange rate regimes and pushed the researchers to explain these choices. Currently, the empirical literature takes into account *the influence of political and institutional variables* upon choosing the regime and suggests that the political instability tends to raise the probability of the flexible exchange rate regimes. The member countries of the International Monetary Fund declare the exchange rate regimes to the IMF, which presents these regimes annually. Before 1999, the countries could declare one of the three possible regimes: fixed exchange rate, flexible exchange rates and free floating exchange rate. This rough classification was rehabilitated in 1999 as a consequence of noticing a considerable level of variation in the official descriptions of policies, classified as ”controlled” or ”more flexibile”. The classification of the IMF regarding the exchange rate regimes allows 8 different catergories since the adoption of a foreign currency as a legal offer for the free floating exchange rate. (IMF, 1999). Table 1 shows a review.

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[1]Mundell, R. (1961). ‘A theory of optimal currency areas’, *American Economic Review*, 51 (September) pp. 657–65; McKinnon, R. (1963). ‘Optimum currency areas’, *American Economic Review*, 53 (September), pp. 717–25.

[2]Poole, W. (1970). ‘Optimal choice of monetary policy instruments in a simple stochastic macro model’, *Quarterly Journal of Economics*, 84(2), pp. 197–216.

[3]Giavazzi, F. and Giovannini, A. (1989). *Limiting Exchange Rate Flexibility*, Cambridge: MIT Press

Table no. 1. Exchange rate regimes (classification of the IMF)

The exchange rate regime	Description
1. Without national currency	Any separate legal offer
2. Monetary Council	Currency entirely supported by foreign exchange
3. Conventional fixed exchange rate	Fixing the exchange rate comparing to other currencies or exchange group with a band at the most of +/ - 1%
4. Horizontal fluctuation band	Straps higher than +/ - 1%
5. Adjustable fixed exchange rate	Fixing the central parity exchanges periodically adjusted in fixed amounts at a exchange rate previously stated or as an answer to the changes into selected quantitative indicators
6. Adjustable fluctuation band	Adjustable fixed exchange rate combined with straps higher than +/ - 1%
7. administrated floating	Active intervention without any obligation regarding a previous exchange rate
8. Independent floating	Exchange rate determined by the market.

Source: FMI, 1999

The option for choosing the type of exchange and monetary policy regime

Starting with 1990, the countries in the Central and Eastern Europe, transition countries, came out of a centralized economic and political system, planned, and enlisted on the long and tough road of reforms and structural adjustments in order to create and develop a functional market economy, a condition necessary to the accession within ”the select group” of the member countries of the European Union, strategic political objective which these countries formulated as soon as they committed themselves in this vast and complex transformation process, with different evolutions and transformations depending, in the first place, on the political will.

In this process, **the option for choosing the type of monetary and exchange policy regime** had also **a fundamental role,** respectively in choosing an optimal combination between the two types of policies. This choice has been made, mainly, depending on the specific of the transition economies, so that to be chosen those monetary policy regimes, respectively the exchange rate regimes (exchange policy), adequate to the economy situation of each country.

The strategic objective which these countries assumed, and namely the accession in the structures of the European Union, determined the respective countries to take into account also other variables with direct implications upon the option of choosing the exchange rate regime and, implicitly, the monetary policy in view of controlling the internal prices and the exchange rate.

Table no. 2. The evolution of the exchange rate regimes in transition economies

Countries	1990	1994	1996	1999
Bulgaria	Conventional fixed exchange rate	Independent floating	Independent floating	Monetary Council
Czech Rep.	Conventional fixed exchange rate	Conventional fixed exchange rate	Horizontal fluctuation band	administrated floating
Hungary	Conventional fixed exchange rate	Conventional fixed exchange rate	Adjustable fluctuation band	Adjustable fluctuation band
Poland	Conventional fixed exchange rate	Conventional fixed exchange rate	Adjustable fluctuation band	Adjustable fluctuation band
Romania	Conventional fixed exchange rate	Independent floating	Independent floating	administrated floating
Slovak Rep.	Conventional fixed exchange rate	Conventional fixed exchange rate	Horizontal fluctuation band	administrated floating
Slovenia	-	administrated floating	administrated floating	administrated floating
Estonia	-	Monetary Council	Monetary Council	Monetary Council
Latvia	-	Conventional fixed exchange rate	Conventional fixed exchange rate	Conventional fixed exchange rate
Lithuania	-	Monetary Council	Monetary Council	Monetary Council
Albania	Conventional fixed exchange rate	Independent floating	Independent floating	Independent floating
Croatia	-	Horizontal fluctuation band	Horizontal fluctuation band	administrated floating
Macedonia	-	Conventional fixed exchange rate	Conventional fixed exchange rate	Conventional fixed exchange rate

*Source: Jürgen von Hagen and Jizhong Zhou The choice of exchange rate regime****,*** *Economics of Transition Volume 13 (4) 2005, 679–703*

As the transition countries had just made their exit of an identical economic and political system, respectivly presented similitudes in the social, politic and economic fields, and had, as a general characteristic, high inflation rates determined partly by the prices liberalization, inflation which made pressures, meaning the depreciation of the exchage rates, it wouldn't have been any reason to expect significant differences, however, the option in the way of exchange rates regimes and economic policies of the respective countries was so diversified that we may say that, in time, the entire range of exchange rate regimes has been experimented, respectively from a fixed exchange rate or fixed exchange rate anchor – monetary councils – up to administrated floating and free floating.

The statement of the official regime indicates the level up to which the monetary authority commits ex ante to maintain the stability of the exchange rate and thus, may influence the expectations of the financial market regarding the evolution of the exchange rate.

As one may notice, all analysed countries, about which we found information, started with a conventional stability (code 3 of the regime), then in 1994, 3 countries were classified as having adopted the free floating (code 8 of the regime) and 1 as applying the controlled floating (code 7 of the regime). Then there were 2 countries with preparations of the monetary council (code 2 of the regime) and 5 which applied thenceforth the conventional fixed exchange rate. In 1996, the countries which had used the independent floating maintained this regime, but it is noticed a trend of changing the conventional fixed exchange rate with the adjustable fluctuation band regime and oblique fluctuation band. In 1999, it is noticed an orientation towards the hybrid regimes, five countries applying the administrated floating, 3 countries the monetary system and only 3 of them the extreme regimes: 2 the conventional fixed exchange rate and 1 the independent floating. It is obvious from this table that the exchange rate regimes adopted in transition economies in 1990 have been very different. Only Estonia and Slovenia haven't changed the exchange rate regimes during the entire period from 1991 until 1999.

The comparative situation of the main transition countries, which became members of the EU in May 2004, offer a few **general conclusions regarding the choice of the exchange rate regime** of the national currency, in fact valid conclusions also for the other canditate countries. A first conclusion is that among the transition countries there are also **differences** and **resemblances,** common trends **regarding the choice of the exchange rate regime,** when establishing the exchange policies and the ability of supporting such policies, as well as the found alternatives.

The most important and visible **difference** refer to **the variety** of the exchange rate regimes chosen in spite of the major similitudes under their initial macroeconomic conditions, within the macro and microeconomic policies and the born external shocks.

The difference between the exchange regimes initially adopted is determined, mainly, by the following **factors**:

- the initial macroeconomic conditions and the exchange rate evolution before starting the transition. In the countries where, before starting the transition, the currency was over evaluated and the inflation was high, choosing the fixed exchange rate regime, after an initial depreciation, seemed compulsory. The initial depreciation is important because the multiple exchange rates are unified, the difference between the official exchange rates and the parallel exchange rates is diminished and the impact of quick liberalizations is attenuated, which must follow, upon the commercial balance and the sectors which produce generally merchandised goods. In the countries where the official exchange rate is proximate to the parallel market exchange rate and to the equilibrium one, the model of the mentioned exchange rate policy is not compulsory, only the small depreciations of the exchange rate are necessary for the attenuation of the differences between the internal inflation and that of the most important commercial partners.
- the macroeconomic policies and the performed structural changes, the sequentially and speed of the reforms, which had a determinant role. Within these, an essential role has the central bank and its independent activity, which consolidates a strong credibility and reputation (as for instance in the Czech Republic, or the lack of its resolution,

situation in which the monetary policy is determined by the tax policy (as for instance in Hungary and Poland);

- the size of currency reserves: in case these are excessively or in the necessary measure in order to ensure the currency stability, the chosen exchange rate regime tends to be the fixed one; where the situation was contrariwise, the chosen currency regime was the flexible one because the fixed one would have destroyed very quickly the currency reserves for sustaining the exchange rate.

Among the transition countries there have been displayed differences both in choosing the initial exchange rate regime and in the ability of supporting the chosen regime.

The sustainability of the chosen exchange rate regime depends on many **factors**, among which:

- macroeconomic policy. When the monetary and tax policies weren't convergent to the exchange policy, unfavorable expectations arose, which undermined the stability of the exchange rates.

- inflation and commercial balance; due to the quick liberalizations of the majority of controlled prices and imports, simultaneous pressures arose, both on the commercial balance and the evolution of the prices; in the economies where the mix of monetary-tax policies was insufficient in fighting such pressures, the currency policy was used in order to attenuate them, which assumed frequent currency adjustments.

- The size of initial depreciation; in the economies where the initial depreciation of the currency was sufficient, the stability of the exchange rate was easily maintained and for a longer period.

Besides the differences regarding the initial choice and the sustainability of the exchange rate regimes, there are also noticed **common trends** in the analyzed transition countries.

A first trend is that all economies of the analyzed countries have recorded a **depreciation of the real exchange rates** around the parity of purchasing power (PPP), apreciation which arose after the initial depreciation since the beginning of transition.

The subsequent appreciation of national currencies reflected also the fact that the significant differences between PPP and the real exchange rates can not be sustainable for a long period. The appreciation of the real exchange rates was consistent with the competitiveness raise of these economies. The appreciation of the exchange rate reflected also inflationist pressures, but regarding these countries, there were higher influences due to the evolution of the prices for the merchandisable or non-merchandisable products.

The prices of the merchandisable products were limited by the liberalization of imports and significant pressures of competitiveness, these increasing easily, while the prices of the non-merchandisable products increased more quickly, especially due to the increase of service sector, under-developed before starting the transition.

Another important factor of exchange rates appreciation was the wages' raise, more accentuated in almost all economies in 1994, this raise being higher than the national productivity raise, which also recorded considerable levels. The real raise of the wages, respectively of the costing per work unit, contributed to the appreciation of the real exchange rate.

The nominal level of national currencies appreciation was different, **the highest level** being recorded in **Poland,** firstly due to the introduction of crawling peg exchange regime; relative high appreciations have been recorded also in Czech Republic and Slovakia due to the maintenance of the fixed exchange rate and high inflation, the lowest level being recorded in Slovenia.

Regarding the **real level** of exchange rates, **the currency which appreciated the most,** reflecting also in the rising of the difference between PPP and the real exchange rate, was the

Slovenian tolar, which recorded a relative high level in 1992, its subsequent appreciation increasing this difference. .

Although the currency which **depreciated the most** was the **Czech koruna**, but due to the initial depreciation, the best convergence of inflation rates with the EU average was accomplished by the Czech Republic.

Concerning Hungary and Poland, the level of the exchange rates went towards PPP under the conditions in which in Hungary the fluctuations were higher, while in Poland the change was gradual due to the constant depreciation of the polish zloty.

When determining the levels of real exchange rates one must take into account also the differences which arise due to the different usage bases of the prices indices, as well as from the differences of productivity in service sectors and the manufacturing ones due to the increases of taxes associated with the tax deficiency financings.

Another common trend of the examined economies refers to the situation of **rethinking the option** for the exchange rate regimes, the made choices being different as the exchange rate regimes were also different.

In Czech Republic, because of the pressures in order to appreciate the currency as a consequence of the influence of stock flows, the exchange rate regime was changed from a fixed one into a crawling peg one, because of the aggravation of balance of the commercial balance and the significant difference between the internal inflation and that of the main commercial partners.

In Poland, the change was contrariwise, from a fixed currency regime to an adjustable band regime (**pre-announced crawling-peg**) whose step was reduced from 1,8% in 1991 up to 1,4- 1,2% in 1995, and in Hungary, the currency regime changed from an adjustable fixed regime to an adjustable variation band regime (**pre-announced crawling-peg**).

In Slovenia, the administrative floating currency regime stayed unchanged, taking into account the necessity of maintaining its flexibility in order to meet the massive stock incomings, inclusively the speculative attacks.

The factors which influence the choice of the exchange rate regime

We may distinguish three groups of factots which affect the choice of the exchange rate regime of a country: *economic base, variable referring to the macroeconomic control and variables referring to the risk of monetary crises.* In a series of works[4] it is emphasized the economic size and the opening of the economy as being important bases. They reason the fact that small and open economies are much more adequate for adopting the fixed exchange rate regimes than the wide and relatively closed economies. Moreover, a country is much more adequate for adopting the fixed exchange rate regimes if its commerce is very concentrated in a certain currency.

Also, it was noticed the fact that the countries having very concentrated production structures are much more adequate for adopting the fixed exchange rate regimes than the countries having a very diversified production, such as the changes of the exchange rate are almost equivalent to the changes from the relative production prices and therefore they are much more useful in order to meet the shocks of demand for the first.

A final consideration is the development of a financial sector of the country. The countries having relatively undeveloped sectors sometimes opt for the fixed exchange rate regimes, because they don't have commercial intruments to lead operations of the

[4]Mundell, R. (1961). ‘A theory of optimal currency areas’, *American Economic Review*, 51(September) pp. 657–65; McKinnon, R. (1963). ‘Optimum currency areas’, *American Economic Review*, 53 (September), pp. 717–25.

opened internal market and because they wish to protect their inceptive banking industries against the high movements of the exchange rate.

Therefore, the low financial development would increase the probability of adopting fixed exchange rate regimes.

Poole's analysis of the optimal instrument of monetary policy (reasons the fact that the fixed exchange rates run better in the terms of a production stability, in the presence of monetary shocks which grow from the internal economy, while the flexible rates run better in the presence of real shocks. These suggests that the countries exposed to high supplying shocks would opt for flexible exchange rates, while the countries which undergo disturbances on the financial and monetary market would control their exchange rates.

The traditional models of the monetary method when determining the exchange rate, contrariwise, are concentrated upon the inflation conveyance between countries and the usage of exchange rate policies of accomplishing the low inflation rates.

Many authors reasoned the fact that the countries whose monetary authorities are distressed because of the low credibility in the policy of reducing the inflation may import the central bank credibility by adopting the fixed exchange rate with a more stable curency.

This point of view was especially valid in the recent years of the transition from socialism to a market economy, when prices liberalization lead to a higher inflation. For the initial macroeconomic stabilization, a fixed exchange rate might provide a nominal anchor for the internal prices in a situation in which the confidence in the internal monetary institutions doesn't exist.

In the recent years, the general trend towards complete or partial stock liberalization directed the attention to the involvements of stock movements for chosing the exchange rate regimes. The fixed exchange rate regimes, when they are mixed with a high level of stock mobility, are exposed to speculative attacks which result from the inconsistencies of fundamental policy or the fulfilling expectations which arise in the context of a multiple equilibrium. The lesson which results is the fact that the countries must avoid the instable combinations of stock mobility and the fixedness of the exchange rate, especially when the internal financial markets are under-developed. The important factots which reduce the risk of speculative attacks are the availability of foreign currency reserves to protect a fixed exchange rate and the assertiveness of macroeconomic policies. The supporting public finances are the key factor in this regard, which play a crucial role in the first and the second model of the monetary crisis of the generation.

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