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# CHANGES IN EXCHANGE RATE REGIMES

Theoretical  
article

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## Abstract

*The experience of recent years shows that it has a fundamental role formation mechanism of the exchange rate in macroeconomic stabilization. Global economic crises, oil shocks have shown the difficulty of floating sustainability by participants in the system. European Monetary System, focused on concerted floating currencies to ECU, was formed under the conditions in which some countries have adopted regional monetary arrangements (EU countries), with such bases currency regimes hybrid that combines specific mechanisms to those of fixe drate free floating. This paper aims to demonstrate the important role that it has the choice of exchange rate regime as a basic element in the foundation of macroeconomic stabilization instruments. Considered an expression of the state of the domestic economy and international competitiveness, the exchange rate is determined by a complex set of external factors or internal stability is a prerequisite for the crisis.*

## Introduction

The issue of exchange rate is of great interest both in theory and in practice, due to its implications on international trade and the real economy.

In recent years, the economic and financial environment experienced profound changes in globalization, financial markets have become interdependent, financial conditions of a region having a direct impact on national financial markets globally. The size of international capital markets has witnessed a real growth following liberalization of national markets and investment opportunities.

It also tends outward opening national markets, mechanisms of economic integration and the exponential growth of foreign exchange transactions. In this context, the exchange rate can be considered the main mechanism influencing the performance of transactions in foreign exchange markets, having an important role in financing foreign trade operations. In the analysis of exchange rate, we deemed necessary to point out that in terms of convertible currencies, the exchange rate should be adjusted freely according to supply and demand. However, monetary authorities may decide to restrict the freedom of national currency fluctuation, depending on economic interests.

Authority policies on exchange rates focus on floating, setting a fixed level or binding to another currency - currency regime of a state form (Rogoff, 2003). There are, in this sense, few options with regard to fluctuations in the exchange rate such as the following:

- the regime of fixed exchange rates in relation to a currency or (rarely) with a basket of currencies: the Euro Area and the currency board. In this situation, the central bank sets the exchange rate and its interventions in the foreign exchange market will lead to an increase or reduction of foreign reserves.

- intermediate exchange regime, whose fluctuations are framed by bands of fluctuation: In case of two ERM (European Exchange Mechanism), the fluctuation band +/- 2.25%. It is characterized by a stabilization mechanism including a lens (constant or variable over a time period) and the maximum possible fluctuation band. If the central bank can not maintain the exchange rate within the fluctuation band set, then depreciation or appreciation is brought into play.

- flexible exchange rate regime implies that the exchange rate is settled freely according to supply and demand in the foreign exchange market. The central bank does not intervene in the forex market (but for exceptional circumstances, generated by a high volatility of the exchange rate) and therefore retains control of foreign exchange reserves. Depending on how common these

interventions are, we talk about floating or managed floating pure.

The experience of recent years shows that it has a fundamental role in the formation mechanism of the exchange rate in macroeconomic stabilization. Global economic crises, oil shocks have shown the difficulty of floating sustainability by participants in the system. The European Monetary System, focused on concerted floating currencies to ECU, was formed under the conditions in which some countries have adopted regional monetary arrangements (EU countries), with such bases currency regimes hybrid that combine specific mechanisms to those of fixed rate free floating.

Choosing an appropriate exchange rate regime is a difficult problem and depends on certain criteria (Ghosch & Ostry, 2009):

- structural characteristics of the economy, its openness;
- wage and price flexibility, fiscal redistribution mechanism;
- diversification of production;
- shocks to the economy may be exposed to internal or external, temporary or permanent, symmetrical or asymmetrical;
- balance of payments;
- credibility of monetary policy, the adequacy of foreign exchange reserves, and strengthening financial system regulation, etc.

By implementing the float currency regime, several objectives are expected to be met (Mihai, 1998):

- formation of real exchange rates determined by market supply and demand, therefore, not by administrative action;
- a mechanism for easily adjusting the external changes without brutal corrections;
- reduction of central bank interventions, hence the courses' determination of the foreign exchange market;
- exchange rate had become the main instrument to each national economy to world market conditions;
- autonomy of monetary policy.

From a practical standpoint, the important role of the choice of exchange rate regime is being a key element in the foundation instruments of macroeconomic stabilization. Considered an expression of the state of domestic economy and international competitiveness, the exchange rate is determined by a complex set of external factors or internal stability is a prerequisite for the crisis.

With the shift to floating rates at regional level, trying to create monetary arrangements to provide a degree of stability in an increasingly volatile international environment is a must.

The currency regime can be approached as a set of rules laid down by a central bank on the functioning of the foreign exchange market, the

market access of economic operators or individuals resident and non-resident foreign currency operations type that can be achieved by this mechanism training of the exchange rate, currency convertibility.

In late September 1999 (IMF, 2000), exchange arrangements of member countries of the International Monetary Fund was as follows: eight countries had a currency board; 44 countries were related courses (peg); 7 countries were horizontal bands of fluctuation; 5 countries have a sliding parity; 7 countries recorded a sliding band; 26 countries had a managed floating exchange rate; 51 countries registered a floating (independent) exchange rate and 37 countries did not have a separate currency.

From the practice of international relations of IMF member countries, the following types of exchange rate are known: fixed courses; flotation; hybrid exchange rate regimes; managed float; lane change; Adjustable bandwidth variation; oblique band of variation.

#### **Characteristics of the exchange rate regime based on fixed courses**

This type of currency regime involves administrative fixing of the exchange rate relative to other currencies or a standard such as, for example, gold. Such a system, which is rather rigid, led to the Bretton Woods Monetary System, the central bank intervened context market in determining the exchange rate. Central banks (such as: U.S. Federal Reserve, Bank of England, Bundesbank in Germany or the Bank of Japan) had to be prepared to absorb any excess foreign currency required or provide an exchange about.

Using fixed exchange rates has the following benefits: reduces transaction costs and exchange rate risk, eliminates depreciation or competitive appreciation, it provides a credible nominal anchor for monetary policy, policy oriented primarily to domestic policy goals, international trade and capital flows are stimulated by higher prices of foreign goods safety.

In relation to the degree of state intervention in the forex market and formation mechanism of exchange rate regimes, there can be found variants with diverse degrees of state control over financial flows denominated in a foreign currency which usually characterize countries poor in resources trying to block domestic capital outflow through exchange rate policy. At the microeconomic level, it becomes important to know the type of currency regime and the conditions under which the state can influence the exchange rate market. There is a correct pattern classification scheme, but taking into account country specific factors - for example, monetary constraints imposed by a fixed exchange rate regime, is relevant in this regard; trilema

macroeconomic policy would be better served as de facto classification (Esaka, 2010). (Table 2)

The classification of exchange rate arrangements of the member countries' currencies of the International Monetary Fund in 2009, includes the following categories (Voinea, 2013):

I. The euro countries - these include: exchange arrangements with no separate official currency arrangements based on the Monetary Council. Exchange arrangements with separate official currency regimes are those that use the currency of another country, and as such, the central bank cannot pursue an independent monetary policy. The Monetary Council established a fixed exchange rate with the application of a set of restrictions, such as issuing only against certain foreign assets.

II. Parities soft - these include: conventional parity arrangements, arrangements stabilized creeping parity arrangements CRAWL-like parity exchange rates with horizontal stripes. Arrangement conventional parity refers to a fixed rate to a benchmark currency and central bank intervenes to keep the rate of fluctuation of  $\pm 1\%$  around a central rate. In the arrangements stabilized to maintain a margin of variation determined by reference to a currency or basket of currencies for at least six months. Parities creeping refer to an exchange rate that is adjusted to the minimum, depending on the modification of certain indicators. Crawl-like arrangements are those arrangements that maintain currency in a range of variation of 2% to a level that reflects changes in the course of the last six months. If parities have horizontal bands, the exchange rate varies within certain limits around a favorable course, with the IMF notification whenever there are changes within bandwidth variation.

II. Arrangements floating - these include: float, free float and other arrangements administered. Since 2009, the International Monetary Fund makes a clear distinction between floating and free floating. Float exchange rate is formed on the market, but the central bank intervenes to influence the course in relation to the balance of payments position in international reserves and international market developments. However, the free float refers to a system where the central bank intervenes only in exceptional circumstances, more than three times in the last six months.

Arrangements for the exchange rates of the member States of the International Monetary Fund are applied in the context of monetary policy strategies of those countries, which include criteria and procedures that are considered against the background of the adoption and implementation of central bank decisions to achieve its primary objective of monetary policy.

Trends that currently exist in terms of currency regimes of IMF countries are (Toderascu, 2013):

- increase flexible exchange rate arrangements in order to effectively manage risk and adopt macroeconomic independent float in response to pressures for some countries currency fluctuations;
- in terms of structure elements, more than 60% of IMF members using the exchange rate as a nominal anchor, and 25% of members have adopted arrangements floating exchange rate used as a reference for the management of its currency;
- some countries have adopted floating although independent, intervening in the forex market to reduce pressure on the exchange rate;
- the dollar remained the most used anchor exchange rate, followed by the euro;
- number of countries that have adopted inflation targeting strategic aim is to increase the flexibility of the framework and the results of other low monetary anchors encouraging authorities in this direction;
- floating currency will make undiversified economy absorb shocks with exchange rate.

A real problem facing small states is that of a developed institutional infrastructure, operating monetary policy, and staff prepared and documented in the data collection and analysis. In small countries, exchange rate volatility may be excessive, given that the currency markets are less liquid (Imam, 2010). Trade effects are important in substantial fluctuations. As a result, over time, floating rates of small states tend to be fixed, the intervention of authorities having linearized role of exchange rate fluctuations.

Structure exchange arrangements in 2013 were as follows – chart no 1

Thus, the choice of exchange rate regime (Klein & Shambaugh, 2006) in a small state is conditional variables. Because states have a small number of people, data collection is not a priority, human capital requiring further analysis is limited, and interpretations are difficult to perform.

Arrangements for the exchange rates of the member States of the International Monetary Fund are applied in the context of monetary policy strategies of those countries that include criteria and procedures that are considered in the adoption and implementation of the decisions of the central bank to achieve its primary objective of monetary policy (Voinea, 2007).

In practice, preferred exchange rate regime, in particular for emerging economies has evolved considerably in recent years. Fixing the exchange rate anchor currency (often the dollar or the German mark) was popular in the early 1990s, especially for countries in transition to a market economy that wished to stabilize the economy after the initial liberalization of prices. The 1990s have

seen an increase in capital account crisis in emerging markets, a sharp reversal of capital flows that led to the fall of currencies and frailty emphasized fixed exchange rate regime.

## Conclusions

The choice of exchange rate regime is one of the thorniest issues of national foreign policy. When choosing currency regime central banks encounter a dilemma: adopt flexible or fixed exchange regime. With flexible exchange rate regime, the foreign exchange market adjusts itself automatically / free. Fixed regime does not imply automatic adjustment of course happens binding / anchoring the national currency of a currency of a particular country or a basket of currencies of several countries. Thus, when operating with a fixed exchange rate, foreign exchange market equilibrium establishment takes place through indirect measures specific economic policy.

Each state is free to choose different exchange rate regimes, depending on the needs of the economy circumstantial. In this context it is important to correctly identify the strategy of choice for regime change. Achieving the goal of minimizing the potential difficulties in applying macroeconomic policy requires every state achievement active foreign policy based on the analysis of comparative advantages of different exchange mechanisms applicable terms of a concrete national economy.

Developments in world practice exchange regimes, tend testifies gradual transition of the world from the fixed exchange rate regime more flexible regimes.

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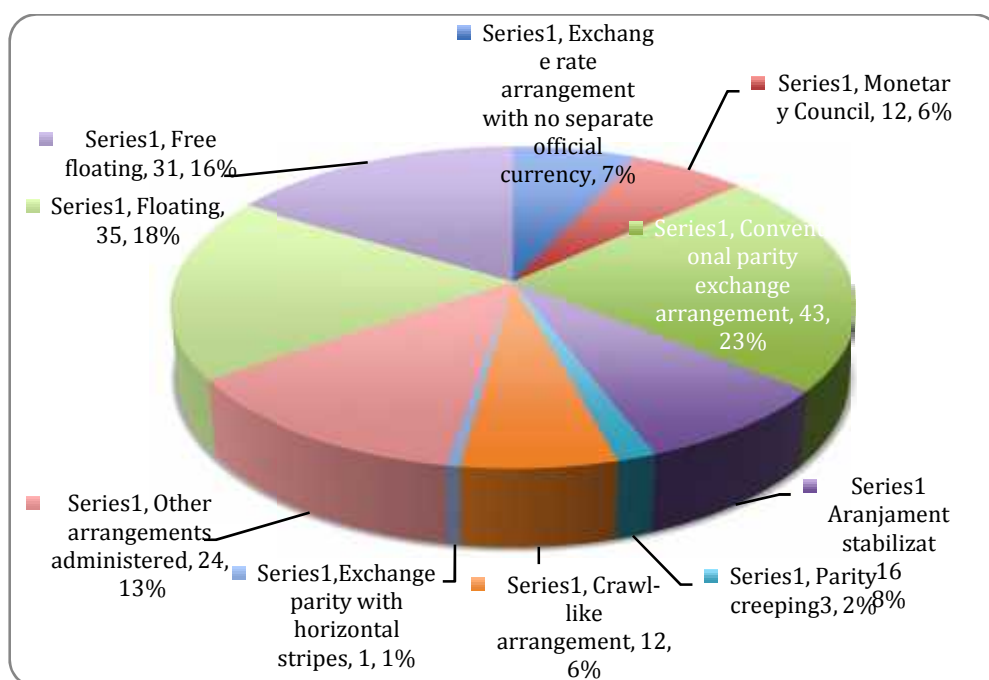
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Table no. 1: Trilema macroeconomic policy: degree of autonomy of monetary policy independent

Exchange rate regimes – <i>de facto</i> – Reinhart i Rogoff (2004)				
Capital control	Fixed exchange rate regime	Intermediate exchange rate regime	Free floating	Free fall
-	<b>REGIM1</b> Fixed exchange rate - CC	<b>REGIM3</b> Intermediate Exchange - CC	<b>REGIM5</b> Free floating - CC	<b>REGIM7</b> Free fall
+	<b>REGIM2</b> Fixed exchange rate + CC	<b>REGIM4</b> intermediate Exchange + CC	<b>REGIM6</b> Free floating + CC	

Sursa: Esaka, T., *International Financial Markets, Institutions and Money*, 2010, pp. 91 – 108

Chart no. 1: Structure of exchange rate arrangements IMF member countries in 2013



Source: Processing by: \*\*\*, Annual Report Exchange Arrangements and Exchange Restrictions, International Monetary Fund, 2013