A Faith-based Initiative: Does a Flexible Exchange Rate Regime Really Facilitate Current Account Adjustment?

Menzie D. Chinn
University of Wisconsin, Madison
National Bureau of Economic Research

and

Shang-Jin Wei
Columbia University
National Bureau of Economic Research
Hong Kong Institute for Monetary Research

March 2009

Summary

The assertion that a more flexible exchange rate regime would promote current account adjustment has been repeated so often that policy makers and economic analysts take it as self-evident that this must be true. There is in fact no systematic evidence supporting this supposition. *Until one finds persuasive empirical evidence, the policy recommendation for a more flexible exchange rate regime in pursuit of current account adjustment is a faith-based initiative – based on something widely assumed to be true, actively peddled to countries as a truth, but with little solid empirical support.*

Indeed, it is not difficult to find counter-examples. While both Egypt and China have a relatively rigid exchange rate regime, Egypt has a relatively fast current account convergence but China does not. On the other hand, while both South Africa and Japan have a flexible exchange rate regime, South Africa has a relatively fast convergence but Japan does not. While we can come up with other examples, there is a limit to how much we can learn from individual cases.

In this paper, we seek to address this deficiency by systematically investigating any relationship in the data between exchange rate regimes and speed of current account adjustment. Rather than using officially announced exchange rate regimes, we appeal to de facto regimes in place. We utilize two well-established and familiar approaches to classifying a country's exchange rate regime on a de facto basis, by Levy-Yeyati and Sturzenegger (2003a,b), and by Reinhart and Rogoff (2004), respectively.

After experimenting with a large number of statistical specifications, we find no support in the data for the notion that countries on a de facto flexible exchange rate regime robustly exhibit a faster convergence of their current account (as a percentage of their GDP) to the long-run equilibrium, regardless of which de facto exchange rate regime classification scheme we employ. This is true when we control for trade and financial openness, and when we separate large and small countries.

To be sure, the current account balance does have a tendency to revert to its long-run steady state; it does not wander off or stay away from the long-run equilibrium forever. This is clearly reflected in our empirical work. However, the speed of adjustment to the steady state is not systematically related to the degree of flexibility of a country's nominal exchange rate regime. We conclude therefore that the popular claim that a more flexible exchange rate regime could facilitate a faster current account adjustment is just a myth.