

The Global Implications of Regional Exchange Rate Regimes

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Summary

A great deal of attention has been devoted to the study of fixed and flexible exchange rate regimes in isolation but no attempt has been made to study mixed systems. In a mixed regime, some countries maintain a system of - more or less - fixed parities among themselves while, at the same time, allowing the external value of their currencies to move freely against currencies that do not belong to their monetary arrangement (the monetary regime of Hong Kong or the EMS are two examples).

This paper attempts to fill this gap. We study the wider implications of a regional fixed exchange rate regime and, in particular, whether such a regime leads to a general reduction of exchange rate volatility or simply transfers volatility from one part of the region to another. And we also examine the factors that determine the type and magnitude of volatility transfer that takes place.

Our key finding is that the extent and type of asymmetries determine the sign - and size - of broader effects. In general, the repercussions on other countries are limited when the countries that fix their currencies are sufficiently symmetric. Even in this case, there are some broader effects when the “ins” have labor markets that differ in terms of flexibility from those in the countries that are outside the monetary arrangement (the “outs”). Or when the “ins” and the “outs” differ in terms of aggressiveness in the pursuit of inflation stabilisation objectives. Nevertheless, the strongest “global” effects emerge when the countries participating in the system of fixed parities do not satisfy the optimum currency area criterion of a similar economic structure. The sign of these effects depends on the characteristics of the country that does the pegging relative to the “leader”. Based on the obtained relationship between country characteristics and volatility, we speculate that global exchange rate volatility under EMU would be more likely to decline were the U.S. - rather than the EU - to target the EUR/USD rate.