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Currency Misalignments and Exchange Rate Regimes in Emerging and Developing Countries

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non-technical summary

Pegged exchange rates regimes are often seen as more vulnerable to financial crises than floating ones. A standard explanation is linked to the appreciation of the real exchange rate, that may occur in these regimes. In this case, the ensuing loss of competitiveness erodes the external competitiveness and the current account balance, which can lead to financing difficulties or even to a speculative attack. This problem is more acute for emerging and developing countries, for they are more likely to adopt a "de facto" fixed exchange rate as evidenced by Reinhart (2000).

The aim of this paper is to check if pegged exchange rates are more prone to overvaluation than other types of regimes. We begin by assessing currency misalignments choosing a standard econometric approach over a large sample of 128 countries from 1974 to 2004. We estimate real equilibrium exchange rates by two econometric relationships: the first takes into account a sheer Balassa effect; the second one adds to the former equation the impact of net foreign assets. The currency misalignment is defined by the gap between the observed real exchange rate and the estimated equilibrium exchange rate. When using successively the two equilibrium exchange rate models, we have two sets of currency misalignments over our sample.

We then compare these misalignments across exchange rate regimes. We use two databases on "de facto" exchange rate regimes classifications, the one developed by Levy-Yeyati and Sturzengger (2003) and the other one provided by Reihnart and Rogoff (2004). Pegged currencies are shown to be significantly more overvalued than floating ones. This result is true with both equilibrium exchange rate models. It is also confirmed, when changing classification method.