

Nominal Exchange Rate Flexibility and Real Exchange Rate Adjustment: New Evidence from Dual Exchange Rates in Developing Countries

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Summary

The role of exchange rate flexibility in economic adjustment has long been a hotly contested issue. One argument for flexible exchange rates is that exchange rate flexibility allows an economy to adjust to shocks by securing needed changes in the real exchange rate through exchange rate rather than through price adjustment. During the modern float period, real exchange rates changes seem to have grown more persistent, nonetheless. The issue then arises as to whether greater nominal rate flexibility promotes real rate adjustment.

This study investigates whether greater nominal exchange rate flexibility aids real exchange rate adjustment based on data from dual exchange rates in developing countries. Specifically, official and parallel rates in both the Bretton Woods and the post-Bretton Woods periods are examined. With official and parallel rates being available for the same historical period, this special data set permits intra-period analysis and minimizes the need to control for any inter-period differences in global and domestic economic conditions.

We do observe substantially greater variability in parallel market rate changes than in official rate changes. Nonetheless, there is no significant evidence that greater nominal rate flexibility tends to yield faster real rate adjustment. Nor is there any significant evidence that greater nominal rate flexibility tends to produce slower real rate adjustment. In other words, based on the information from dual exchange rate systems, no systematic relationship can be found between nominal rate flexibility and the speed of real rate adjustment. The result holds for both the Bretton Woods and the post-Bretton Woods data. With official rates pegged to the dollar, many developing countries use parallel exchange markets as a back-door channel to facilitate real exchange rate adjustment. The evidence suggests, however, that these parallel markets often fail to speed up real rate adjustment.