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# Determination of Exchange Rate Regimes in an unstable economy

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**Abstract**: Choosing a suitable exchange rate regime has not always represented an easy step to take. An appropriate regime affects the impact that this regime will have on the design of monetary policy in a given state, in level of transactions and their costs thereby affecting the balance of payments and providing an important financial impact .Throughout the review of existing literature, gaps that it can represent and taking into account the constraints that may be also presented, this article aims to introduce a clear picture of the current problems and find ways to improve them. In terms of an unstable economy, it is necessary to analyze the exchange rates, the volatility of their ongoing and their impact on key macroeconomic indicators. Fluctuations in exchange rates can often incite the economy and financial analysts or policy makers, to review monetary policy, fiscal and macroeconomic risks.

**Keywords**: exchange rate regime, balance of payments,fluctuations ,monetary policy,macroeconomic policy.

## I. INTRODUCTION

The choice of exchange rate regimes has always represented a significant challenge for different countries and has evolved significantly over the years. Referring to Bordo [1] in the early twentieth century, the choice was clear – the standard of the gold was common and all developed countries embraced it.

In the early twenty-first century, the choice became clearer and it was shifting to fluctuating exchange rates. In order to determine the most appropriate exchange rate regime, we should have a look back in the history of exchange rates. Referring again to Bordo [1], we need to ask some questions in order to get some answers: Which monetary regime is best for economic performance? The one based on fixed exchange rates including the gold standard or a regime where exchange rates are fixed by allowing the possibility for interference as the Bretton Woods [1] system and the European monetary system (EMS)? Or better yet a regime based on floating exchange rates? These questions affect a number of important issues that arise in an economy. The key advantage of fixed exchange rates is their role in reducing transaction costs. Meanwhile, a major disadvantage relates to the fact that in a world where there are implications regarding wages and prices, the benefits from reduced transaction costs, can diminish the importance of costs by a more volatile output and employment level.

A second issue relates to whether the exchange rate regime provides protection against financial shock or financial imbalances and monetary policy independence.

Under a fixed exchange rate regime, monetary policy is coordinated, can provide effective protection against fluctuations in monetary joint bid, but not to variations in specific countries.

Under floating exchange rates, fluctuations in specific countries could be offset by an independent monetary policy.

This study is focused on some key objectives which are intended to be met by the selected methodology which will seek to combine qualitative and quantitative methods. These objectives are presented as below:

1) First it aims to demonstrate through comparative analysis, the importance that a suitable choice of exchange rate regime represents.

2) Second, to analyze the advantages and disadvantages of choosing a regime focusing on the impact that it brings to the country's macroeconomic performance.

3) Third, to show the importance of exchange rates and fluctuations in economic and financial choices that involves some important players in the economy.

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## II. METHODOLOGICAL APPROACH

This survey has been based on of analyses various local and regional data related exchange rates and fluctuations in economic and financial choices that involves some important players in the economy.
Hypotheses of the study: To facilitate and contribute to the realization of the objectives set in this paper, some main hypotheses have been built and will by using various econometric methods. More specifically they can be summarized as follows:

1) Currency exchange rates are determinant factors in the economy.
2) Exchange rate regime affects the effectiveness of macroeconomic policy.
3) Currency exchange rates are an important indicator of macroeconomic performance in times of crisis.
4) Currency exchange rates mitigate the effects of the economic crisis.

## III. RESULTS AND DISCUSSIONS

According to Richard Cooper, the choice of exchange rate regime has not always been so complicated; during most of the modern period, as it practically dictated by the conventions, or the internationally accepted rules of uncontrollable external circumstances.
But according to [2], the first period includes the years 1870 to 1914, during which many states adopted the gold standard for their internal cash, implying fixed exchange rates of currencies basket national government under modest volatility allowed from countries.
This relatively uniform regime - even though some states had not exchangeable gold coins during that time - was interrupted by the onset of the First World War.
The period from 1914-1946 was characterized by variations both between countries and over time, with the widespread and episodic use of exchange controls, periods of fluctuating exchange rates, where is important to be mentioned a failed attempt in the late 1920s to restore a variant of the gold standard and an attempt in late 1930 to stabilize exchange rates between certain currencies, important to coordinate monetary policy with market intervention.

**Importance of exchange rate regimes:**

Without intention to oppose the general view that the period before 1973 was dominated by fixed exchange rates and the period after 1973 was dominated by fluctuating exchange rates, if we get a look to developed countries and developing countries, we can see and under see a high degree of heterogeneity between states in this regard. [2] [3] [4].
From a survey done for the exchange rate regimes, it raises the question whether large fluctuations may occur in the composition of a fixed regime, the intermediate or floating exchange rates over time.
There are two paradigms that can respond to the question posed.
The first paradigm which is also called the bipolar perspective, states that intermediate regimes are not sustainable and threaten to disappear if we have liberalized capital flows.
The second paradigm emphasizes the fact that when we have a regime in which exchange rates are fixed to certain threshold, then the regime will become more sensitive to external factors, especially crisis, so it is better to pass from such a regime to a more fluctuating regime over time .A large number of countries had a fixed exchange rate or floating in April 2009 and a small number of states had an intermediate regime in practical exchange rates. This means that different countries feel the need to choose between what is fixed and what is flexible. In addition, virtually fixed rates and states where they are applied, are larger in number than fluctuating exchange rates and this fact rejects the second paradigm which suggested that fixed rates are more and more sensitive to shocks .Although it is difficult in practice to be able to characterize the nature of exchange rate regimes, [5] [6] [7] among others, dictated that the fall of intermediate regimes in the early 1990s was 70 % and in 2006 was reduced to 40 %. They also found that among developed countries, intermediate regimes of exchange rates were disappeared. This trend clearly justifies the bipolar view which was related to the level of development of a country and also reflected monetary unification in Europe [7].

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**The choice of Exchange Rate Regimes**

Standard theory suggests that the choice between a regime of fixed and floating exchange rate should be guided by the desire to minimize inconsistencies in the level of output and employment. Despite this fact, the nature of shocks to an economy may be more diverse and happen for many reasons. If an economy is exposed to a nominal shock as a result of demand and supply for money, the choice of a fixed regime is more natural because it serves to a better shock absorption .If the shock is real (as a result of fluctuations in foreign real exchange rate), linked to the level of production, the application of a floating regime will be more appropriate. However, set theory is not very suitable for expanding market economies, since no exchange rate regime can prevent macroeconomic turbulence [6]. Indeed, the regime has a secondary importance in the economies in the growing markets. What really matters for these economies are: the quality of institutions, including fiscal, financial and monetary institutions. For example, in a regime of fixed exchange rate, an irresponsible fiscal policy could result in crisis because it could jeopardize the break fixed rate and currency depreciation deeply troubled balance sheet as a result of dollarization of liabilities. On the other hand, fluctuating exchange is not a solution because it creates large devaluations. Despite everything, both fixed and floating exchange rates have their advantages and disadvantages. In general, there is the thought that fixing the exchange rate can serve as a tool for policy fiscal discipline. In the same time, the fixing of the exchange rate reduces the premium rate by causing cheaper public sector spending and this can be a sure recipe for crises. Fixed exchange rates are more valuable than floating, especially for developing countries, if they are engaged in economic integration and if adjustments as a result of asymmetric shock can be corrected through mobility of production factors, the high flexibility of the labor market or the growth of intra -industry trade.

Finally, we can say that it is important to keep the exchange rate stable in order to promote macroeconomic and financial stability. Next, the floating rates are not less important because we can say that such a regime allows domestic monetary policy to behave independently, especially if capital flows are fully liberalized. There are even external factors that affect exchange rate regimes and they can be grouped in three lines as following:

1) The stabilization of exchange rates,
2) Achieving free movement of international equity and
3) The use of monetary policy for domestic purposes.

Free flow of capital internationally regarded as a prerequisite for participation in the international markets, to fix the exchange rate or not and at what level of economic development to decide on this matter, become essential for macroeconomic policy orientation, especially for a small country. So a certain state, if we refer to those states as well as Albania where the economic situation is still in the initial stages, it becomes immediately clear that one of their objectives in policy is the one combining the achievement of internal goals for economic development and international monetary integration.

## IV. CONCLUSIONS AND RECOMMENDATIONS

1. Flexible or variable exchange rates are claimed to have some advantages and disadvantages. It is important to analyze both aspects in order to decide if countries need to change their macroeconomic policy. Since most countries nowadays have embraced a more liberate exchange rate regime allowing exchange rates to flow freely or are freely managed, it is important to evaluate both good and bad sides of this regime.

2. Flexible exchange rate provides an independent monetary police by making it possible for each country to follow their monetary domestic objectives without being influenced by other countries even if they may be a part of it.

3. By adapting such a regime, it is easier for countries to absorb and face financial shocks, since there is a certain rate of financial, monetary and fiscal independence and the cascade effect is isolated.

4. A floating exchange rate regime promotes economic development in a country since it is more flexible and responds easily to the changes dictated by a different monetary policy and it also affects a higher rate of employment.

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5. There are also some negative effects caused by flexible exchange rates and according to these ,we can say that they can cause instability and uncertainty, by influencing the volume of international trade and direct foreign investments.

6. The possibilities for changes in the consumer goods prices and also in the export and import activities caused by continue fluctuations in exchange rates can destabilize one country's economy structure.

Based on what we have concluded, we recommend as follow:

1. A certain country should take into consideration many factors when it comes to the determination of the proper exchange rate regime. Since, many developed and developing countries have embraced a floating exchange rate regime, they should also try to improve the unnecessary movements of capital throughout speculative actions.

2. Also we suggest that countries with this kind of exchange rate regime must soften the inflationary effect since flexible exchange rate system involves greater ability of inflationary impact of exchange rate depreciation on domestic price level of a country. Inflationary increase in prices leads to further depreciation of the external value of the currency.

3. In conclusion, the determination of an exchange rate regime somehow represents a difficult choice for many countries especially for developing countries that still face economic issues and are seeking the best solutions to absorb crises negative effects. So macroeconomic analyses would be needed to better face the economic, fiscal and monetary changes and also maintain a certain rate of independence from other countries.

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