Exchange Rate Regimes – A periodical overview and a critical analysis of exchange rate regimes in Kosovo

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Abstract

Exchange rate regimes and the monetary policy are the key instruments governments use to achieve their economic and financial objectives. Moreover, due to global financial crisis the latter instruments get more importance. Empirical evidences show that exchange rate regimes in Kosovo and its monetary policy throughout their development were mainly influenced by different political and historical developments. In regard of Euroisation of monetary system in Kosovo it was found that this action generated macro - financial stability in terms of inflation and price fluctuation. However, in terms of microeconomic aspects, the unilateral adaptation of Euro as the official currency of Kosovo failed to provide microeconomic advantages such as to export stimulation, and so forth. The main exchange rate regime systems were discussed focusing in their advantages and disadvantages, and it was concluded that there is no commonly accepted theory regarding the optimality of exchange rate regimes. In addition, the global financial crisis impact in the financial system of Kosovo is also discussed and it was found that negative impacts of global financial crisis were moderate and indirect.

Keywords: *Exchange rate regimes, monetary system.*

Introduction

In a historical retrospective the governments all over the world in order to attain their economic objectives have used various macroeconomic instruments. Monetary policy and the instruments derived from it have been and remain to be one of the key tools in achieving macroeconomic stability and financial advantages for a certain country. Exchange rates regimes are one of the key instruments governments use to achieve their financial and economic objectives. Exchange rates regimes as variable instruments change and are determined from the domestic, regional and global political, economic and financial situation. Frankel (1999) in the article "No single currency regime is right for all countries or at all times" claims that "The appropriate exchange rate regime varies depending on the specific circumstances of the country in question (which includes the classic optimum currency area criteria, as well as some newer criteria related to credibility) and depending on the circumstances of the time period in question (which includes the problem of successful exit strategies" (p. 2). According to Rose (2011) countries choose their exchange rate regimes based on national characteristics, such as geographic, political, demographic, or institutional features. Therefore, depending on external and internal circumstances an exchange rate regime for a certain country may create advantages, whereas for another one may cause disadvantages and monetary inefficiency. In correlation to the latter conclusion this paper is about to analyze various exchange rate regimes and their advantages and disadvantages. Moreover, the paper is going to provide

a critical analysis of the historical development of the exchange rates regimes in Kosovo, accompanied by international financial crises impact in the economy of Kosovo.
The rest of this paper is organized as follows. The next section of the paper provides some literature review about the determinants of exchange rate regime in developing countries, whereas in second part of literature review the main exchange rate systems will be discussed, focusing in their advantages and disadvantages. In the third section of the paper a periodical overview of the practical experiences of exchange change regimes in Kosovo in last three decades is provided. The fourth section of the paper provides a critical analysis of global financial crisis impacts in financial market of Kosovo. Conclusions are drawn in the fourth section.

Literature review

Recently many scholars have analyzed the issue of exchange rate regimes. Berdiev, Chang and Kim (2012) in their most recent article "The political economy of exchange rate regimes" found that government ideology, politics, and globalization, are important factors determining the exchange rate regimes Furthermore, the latter authors claim that left wing governments are more likely to choose flexible regimes, whereas in right wing countries with pro globalization governments, the likelihood of imposing fixed regime is much higher. Guclu (2009) has also analyzed the factors determining exchange rate regimes in emerging markets economies, finding that economic development, inflation and political factors were the key determinants of exchange rate regimes. Markiewicz (2006) analyzing the exchange rate regimes in economies under transition, found that the size of economy and the geographical concentration of trade are significant determinants of exchange rate regimes.

Literature review on exchange rate regimes

In order to achieve their economic objectives governments impose various exchange rate regimes. Jeff Madura approaches to the exchange rate systems depending to the level controlled by government and classifies them as follows:
1. Fixed exchange rate regime
2. Freely floating exchange rate regime
3. Managed floating exchange rate regime
4. Pegged exchange rate regime

Fixed exchange rate regime

Fixed exchange rate regime is a system under which the exchange rate currency is kept fixed by the government, however, formally allowed to fluctuate within narrow boundaries. According to Krause (1971) in an environment with ideal political and economic institutions a fixed exchange rate system could work admirably. As we move from the ideal conditions to an environment with less credible institutions the adaptation of flexible rates is more preferable. However, the same author claims that there might be some conjured circumstances where neither of these systems will work effectively. Blomberg, Frieden and Stein (2005) relate the issue of fixed exchange rate regimes to the economic and political factors as the key determinants to the likelihood that a government will impose fixed exchange rate. The mentioned authors suggest that if manufacturing and tradable sector are developed and important, because of the pressure of business community, it is less likely that government will impose fixed exchange rate system. In correlation to the latter findings, according to Von Hagen and Zhou (2005) countries situated at the geographical areas where foreign trade is concentrated are more likely to adopt fixed regimes. Fixed exchange rate regime depends also from the external financial environment. As suggested by Ma (2009) if the external environment is less stable than the internal one, because of the monetary shock effects from the foreign countries, fixed exchange rate system would not be the optimal one. Moreover, according to Broda (2004) fixed regimes have a disadvantage in their ability to absorb real shocks of the economy compare to flexible ones.

Freely floating exchange rate regime

In a freely floating regime the exchange rate of a currency is determined purely by market forces. As suggested by Aliber (1975) the advantage of floating system as a flexible exchange rate system is that the government is not committed to a particular parity, as under a pegged rate system. Moreover, the same author claims that with floating rates governments can pursue an independent monetary policy since central bank may control the nominal and real economic variables. King (1977) suggests that a significant advantage of the floating rates is that international trade remains unaffected by international inflation, that's because the trade financial transactions are based on real rather than in nominal factors. Therefore, under this system a country is able to absorb the shocks of foreign exchange market, because floating exchange rate system has the ability of automatic adjustment. In this regard Broda (2004) suggests that the advantage of flexible regimes over fixed ones in their ability to absorb the problems in economy against real shocks. However, some recent research, such as Abbott and De Vita (2011) regarding inflation and exchange rates regime in industrialized and developing countries indicate that costs of inflation under floating exchange rate are higher rather compare to fixed or intermediate rates. Moreover, Sjaastad (2008) claims that floating exchange rate after the collapse of Bretton-Woods has been the major source of price instability of the gold market. Since gold market was dominated by US dollar, any change in the value of dollar, such as its devaluation or appreciation would have significant effects on the price of gold in other countries, thereby, destabilizing the prices and market of the latter countries.

Managed floating exchange rate regime

Managed floating is a specific - pragmatic exchange rate regime under which the exchange rate of the currency is allowed to move freely, but only in daily basis. Therefore, this exchange rate system could be classified as something between fixed and floating exchange rate system. We consider it pragmatic since it uses the benefits of floating-flexible exchange rate system, responding to the international exchange rate fluctuations by automatic adjustment and on the same time if the international exchange rate patterns do not move to the wanted direction, government steps in, in order to fix the rate for a certain period of time. Akiba, Iida and Kitamura (2009) in their article "The optimal exchange rate regime for a small country" claim that from the year 1980 many countries have officially adopted floating exchange rate system, moving from peg. However, the same authors analyzing this trend found that the transition from peg to floating was a "de jure" move, since most of the countries "de facto" established a managed floating exchange rate system. They did that in order to intervene in the foreign exchange rate market. The same authors have conducted a study regarding the exchange rate regimes, such as floating, managed floating and pegged in a relation to welfare of a small country. In their research they found that floating exchange rate system is the best system for a small country. However, they also claim that if the level of government intervention to exchange rate market is high, than the best and "de facto" exchange rate system remains managed floating.

Pegged exchange rate regime

Pegged exchange rate regime emerged after the Bretton Woods agreement, where most of the countries pegged their currencies to the gold and later one to US dollar.
Under this exchange rate system governments peg their currencies to a strong convertible currency such as US dollar, Euro, or to some other currency, moving in a line with the fluctuations of the respective currency. According to Aizenman and Glick (2008) the main advantage of the pegged exchange rate as a monetary instrument was considered to be its ability to achieve inflation stability. However, the same authors argue about the pegged exchange rate system overall effectiveness, claiming that in an exit option from peg to another exchange rate system the adverse negative outcomes would be much higher, which would result to a much higher welfare loss to the economy. Esaka (2010) in a study about pegged exchange rate regimes of 84 countries in a time period of 1980 – 2001 found that pegged regimes decrease the chances of currency crises compare to floating ones. Moreover, what is interesting, it was found that the liberalization of capital movement under pegged regimes reduces the chance of currency crises compare with other exchange rate regimes. However, Hall (2009) argues that the growth and liberalization of capital movement has brought to increase of the cost of pegged regime maintenance, thereby, forced some developing countries to find alternative regimes. In this regard, Eichengreen and Garcia (2006) suggest that pegged exchange rate is more suitable for countries applying restrictions on capital mobility.

Exchange Rate Regimes in Kosovo

In terms of historical and political developments affecting the monetary system of Kosovo, it is considered that time period from 1980 – 2012 may provide significant insights about the development of exchange rate regimes. This time period is divided in three parts. a. The time period from 1980 to 1990 when former Yugoslavia was still a legal entity recognized worldwide, b. The time period from 1990 to 1999 when Republics of former Yugoslavia started partition, c. The time period from 1999 - 2012 when former Yugoslavia (Serbia) lost control and United Nations took jurisdiction over Kosovo, which was followed by declaration of independence of Kosovo on February 2008?

a. Although Yugoslavia was considered as an economic power and leader of Nonaligned Movement, during the 8th decade of the last century faced serious economic difficulties. Therefore, in the year 1990 as a part of austerity measures undertaken by famous economist and the Prime Minister of former Yugoslavia Ante Markovic, convertible dinar was introduced, switching exchange rate from managed float to fixed regimes. The goal of the austerity measure was to combat the inflation, which had reached a record rate of 2,600 percent by the end of 1989. The austerity measures lead by Markovic although seen by many economists and politicians with skepticism, resulted in stabilizing the economy during the year 1990. However, political tensions amongst the federal entities of former Yugoslavia resulted in military conflict, hence, reforms of Ante Markovic although seen promising couldn't be implemented in a long term.

b. The time period from 1990 to 1999 is characterized with huge economic and political problems, which resulted with war in Republic of Croatia, Bosnia and Kosovo. Since federal government main interest was financing the military campaign, the exchange rate was switched from fixed imposed by Ante Markovic to floating. This time period was characterized with highest inflation in the history of former Yugoslavia. Moreover, the federal financial institutions lost their financial credibility and moral integrity. As suggested by Krause (1971) as we move from the ideal conditions to an environment with less credible institutions the adaptation of flexible rates is more preferable. Although, the dinar was official currency in circulation in Kosovo, during that time period German Mark was de facto the currency used to manage daily financial transactions.

c. In the year 1999 German Mark has been adopted as the official currency. As the Euro zone was established and the Euro was introduced as the official currency of the Euro zone countries, the Euro was adopted unilaterally by the provisional United Nations Mission authorities as the official currency of Kosovo. Euro remained an official currency even after the Independence Declaration of Kosovo on February 2008. Euroisation of monetary system in Kosovo played crucial role in combating inflation, which according to Central Bank of Kosovo at that time rached 40%. Moreover, according to Michel Svetchine, Euroisation in Kosovo contributed to reduction of cash in circulation, monetary stability, reduction of transaction cost, and also secured a macroeconomic stability. Turbedary (2006) expressing an optimism regarding future economic development of Kosovo due to Euroisation predicted a boost of the economy and significant increase of foreign direct investments inwards in Kosovo. However, according to data of Central Bank of Kosovo the foreign direct investments in Kosovo didn't show any significant increase after the adaptation of Euro as official currency of Kosovo. Moreover, the foreign direct investments inwards in Kosovo showed a tendency of decline.

International financial crisis effects in Kosovo and a critical analysis of monetary policy

Since most of the financial institutions of Kosovo were not integrated in the global financial environment, the financial crisis did not have serious negative effects to its economy. However, although not integrated, the negative effects of crisis indirectly affected Kosovo's economy. These indirect effects were expressed in decline of remittances by 5.5% in 2009. Foreign direct investments in 2009 compared to previous years according to Central Bank also showed tendency of decline. The only institution directly affected due to international financial crisis was Kosovo Pension Savings Trust, which assets were invested in international financial markets. Kosovo Pension Savings Trust invested in the international market 55% of assets in shares, 5% in cash and 40% in market securities (Central Bank of Kosovo, 2006). This resulted in 8% return on investment. In 2007 return on investment decreased significantly to 1.7%. Whereas in 2008, due to financial crisis the net return on investment was negative -26.8%.

In regard of current economic situation in Kosovo related to exchange rate regimes system impacted by Euroisation, the question is! Is the adaptation of Euro as official currency in Kosovo the right choice? In terms of securing macroeconomic stability, the answer is definitely, yes! However, the Euroisation in Kosovo has also its drawbacks, which are related with inability of government to manipulate with exchange rate in order to provide microeconomic advantages, as well as to make its exports more competitive by devaluation of its currency. If Kosovo had its own currency it could devaluate or appreciate it in order to attain the latter goals. Moreover, Kosovo's political, economic and financial heritage differ compare to the countries of Euro Zone. Hence, it is arguable that the Euroisation is the right option for the economy of Kosovo.

Conclusions

This paper provided thorough analysis regarding exchange rates advantages and disadvantages, exchange rate regimes applied in Kosovo during the time of former Yugoslavia and after 1999, and a critical analysis of monetary policy in Kosovo followed by an analysis of global financial crisis effects in financial system of Kosovo.

Fixed, Freely Floating, Managed Floating, and Pegged Exchange Rate regimes were introduced. It was concluded that different countries used different exchange rates during their development process, depending on their geographical, political, economic specifics, and so forth.

Kosovo's exchange rate regimes and the monetary policies were described in the paper as well, from the time it used to be part of Yugoslavia. Tying up with a strong currency such as Euro resulted in success, especially in tackling inflation, and providing a stable financial sector with continuous growth. However, the monetary policy based on Euroisation has its drawbacks, especially, in terms of foreign trade policies related to export of goods, due to technical impossibility to devaluate or revaluate the national currency.

Since Kosovo economy is small and not developed at the level of the regional countries, as well as not integrated into the global financial system, it was not directly affected by financial crises. The financial crises impacted only the Kosovo Pension Savings Trust, which assets were invested in the international financial market.

After a careful and thorough literature review of exchange rate regimes, a conclusion can be drawn that there is no commonly accepted theory regarding exchange rate regimes.

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