MY TRADING PARTNERS' EXCHANGE RATE REGIMES AND MY EXTERNAL ADJUSTMENT

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As a mean for global rebalancing, greater exchange rate flexibility has been emphasized by international organizations such as the IMF and the G20. Chinn and Wei (2008) argue that this recommendation has no theoretical base by showing no evidence that a country on a more flexible exchange rate regime robustly exhibit a faster convergence of their current account to the long run equilibrium.

They examine how its exchange rate regime in a certain country affects the speed at which its current account reverts to the mean value, using an autoregressive equation of current account balances. The AR1 coefficient of the equation indicates the speed of current account adjustment or convergence. A larger coefficient implies slower adjustment of current account balances and vice versa. We employ the same methodology, but show different results from Chinn and Wei (2008). The difference comes from a new consideration of the effect of trading partners' exchange regime, which they didn't take into account.

Our main finding is that a flexible exchange rate regime promotes current account adjustment if the impacts of trading partners' exchange regime on external adjustment are considered as well as its own one. For the empirical analysis, we use the data sample consisting of 99 countries from 1970 to 2007, which covers 21 advanced economies, 39 emerging market economies, and 39 developing economies. Our findings demonstrate that a country's adoption of free floating exchange rate regime promotes its trading partners' external adjustment. Therefore, the notion that the world economy can accelerate global rebalancing by enhancing exchange rate flexibility cooperatively is not simply based on faith but supported by empirical evidences.