Explaining REER Misalignment: The Role of Currency Regimes, Financial Openness & Trade Agreements

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Dr. Zunaira Aman

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Supervisor: Prof Sushanta Mallick

Queen Mary University of London

Faculty of Humanities and Social Sciences

School of Business and Management

Abstract

In this chapter, we further investigate why some countries are more price competitive relative to others by estimating exchange rate misalignment (external competitiveness) using the earlier model and then assessing whether structural and policy differences between countries, namely quality of institutions, financial openness, and trade agreements, can explain the extent of misalignment. Given that REER is panel-stationary, we found the unit root when the sample is considered region-wise and country-wise, suggesting a possible long-term cointegration with other determinants. For this reason, we use pooled regression analysis employing data from 35 countries across six different regions over the period 1975-2014. Firstly, we found that intermediate regimes limit the degree of REER misalignment with better financial openness as compared with the other two regimes. Secondly, this study also concludes that non-reciprocal trade agreements tend to reduce the extent of misalignment. In contrast, economies that are part of free trade agreements also limit the level of misalignment provided with a better level of financial openness. Furthermore, this study also finds that misalignment is persistent under fixed regimes and can be corrected in intermediate currency regimes combined with greater financial openness. Thirdly, in fixed regimes, the degree of misalignment could be reduced along with promoting the better quality of institutions.

Key Words: Financial openness, capital inflows, real effective exchange rates, misalignment, institutional indices, trade agreements