HIGHLIGHTS from CHAPTER 4
PEG AND CONTROL? THE LINKS BETWEEN EXCHANGE RATE REGIMES AND CAPITAL ACCOUNT POLICIES
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Key Points

- Exchange rate regimes and capital account policies play a major role in helping emerging and developing countries prepare for economic risks.
- Developing countries are more likely to opt for capital flow restrictions if they also have fixed exchange rates.
- The preference for greater capital controls and less flexible exchange rates appears to be more prevalent at lower levels of development.

Exchange rate regimes, capital account policies, and the response to shocks. Developing countries need to consider policy responses to adjust to external shocks as they prepare against various downside risks. Among these policy responses, some countries might rely on exchange rate flexibility as a buffer, some might aim to minimize currency fluctuations, and some might consider capital flow measures as they seek to keep some degree of monetary policy control.

The link between exchange rate regimes and capital account policies. Developing countries are more likely to have capital flow restrictions if they also have fixed exchange rates. There appears to be a positive, statistically significant partial correlation between the extent of capital controls and the propensity to peg.

This link varies across different per capita income levels. The positive association between pegs and capital controls appears to depend on the level of income per capita. It is statistically significant for frontier markets and other middle- and low-income countries, but not for the wealthier emerging market and advanced economies (Figure 1).

Policy issues. In countries with lower levels of development—proxied by lower levels of income per capita—policymakers might be constrained to tightly control both the exchange rate and the capital account. Alternatively, countries that are more financially developed might find it harder to control the capital account regardless of currency regime given their high level of international financial integration. In addition, these choices could also mainly reflect preferences among policymakers in lower-income countries for tighter exchange rate and capital account controls.

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1 This essay was prepared by Carlos Arteta, Michael Klein, and Jay Shambaugh. It is based on materials compiled from its background paper (Arteta, Klein, and Shambaugh forthcoming).
2 Frontier markets are developing countries that tend to be smaller and less-accessible.
Figure 1: Pegged regimes and capital controls across income levels

The association between pegged exchange rates on capital controls varies with the level of income per capita for frontier markets and other middle- and low-income countries. However, there is no significant association of this kind for emerging markets or advanced economies.


Note: This figure shows the total impact of pegging on the likelihood of capital controls at different income levels, by including an interaction between the logarithm of income per capita and the logarithmic transformation of the peg exchange rate variable. In this figure, the thick solid black line shows the estimated value of $\partial \ln(\text{capital control}) / \partial \ln(\text{peg})$ for each level of income per capita, and the dashed red lines show the 95 percent confidence interval of this estimate. The vertical yellow line shows the point after which this partial derivative is no longer significant at the 95 percent level of confidence. The points on the solid line show the average values of income per capita for the four country categories.