Why is Managed Floating Adopted as a *De Facto* Exchange Rate Regime?

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This paper examines the welfare implications of the managed floating as an intermediate regime. The number of countries under the pegged exchange rate regime has been decreasing since the collapse of the Bretton Woods system while the number of countries under the freely floating exchange rate has sharply been increasing since 1980's. For the growing transition from peg to freely floating, Calvo and Reinhart (2002) analyzed the behavior of exchange rate, international reserves, and nominal interest rate volatility, and concluded that emerging markets usually considered to be floaters are subject to the "Fear of Floating" syndrome. According to their examination, most countries that claim officially a domestic exchange rate to be floating actually do not keep their words taken at their face value. In other words the *de facto* managed floating, which allows the monetary authority to intervene in some way in the foreign exchange market, is likely to be selected in many countries.

We construct a rigorous theoretical model to examine the welfare implications of the managed floating and to find room for the intermediate regime being adopted as a *de facto* regime. Specifically, modifying and generalizing the Hamada's model (2002), which compares a single peg to dollar and a basket peg with freely floating in multi-currency world based on the framework of Barro and Gordon (1983), to accommodate intervention policy, we compare the expected losses under three alternative regimes; freely floating, a pegged exchange rate, and the managed floating.

We show that, with some restrictive conditions on deviations of the exchange rate from its equilibrium level and the difference in the target rate of increase in real wages, the welfare level of the central bank of the small country under the managed floating is possibly higher than that under other regimes, because the private sector misconceives the exchange rate regime that the central bank actually selects. This partly explains the central bank's sentiment of "Fear of Floating", that is to say, why the managed floating is widely adopted as a *de facto* regime.