The Mechanics of a Successful Exchange Rate Peg: Lessons for Emerging Markets

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Exchange rate pegs collapsed in many countries in the 1990s, leading to dreary assessments of the merits of pegged exchange rate regimes. Whether one points to the failure of Mexico’s peg in December 1994 or to the sharp devaluations in East Asia in 1997-98, in Russia in August 1998, and in Brazil in January 1999, the collapse of unilateral exchange rate pegs often preceded acute financial and macroeconomic crises. Despite recent failures, however, exchange rate pegs remain a prevalent policy choice. Calvo and Reinhart (2000) argue that the exchange rate volatility that accompanies a floating exchange rate regime is particularly onerous to emerging markets, and thus can be a worse policy choice than a peg that reduces the variability of the exchange rate, even if it does not attain the complete confidence of investors. Given the continued prevalence of pegs, it is worth seeking additional understanding of what makes a peg successful or not.

For this reason, we find it useful to study what was arguably the most successful unilateral exchange rate peg: Austria’s peg to the Deutsche mark prior to Austria’s entry into the European Monetary System in 1995. An estimated model of Austrian monetary policy mechanics helps identify salient features that made the Austrian peg credible to the public. We then apply the same model to monetary policy in Thailand: among the East Asian countries that eventually devalued, Thailand had maintained the tightest peg to the U.S. dollar prior to July 1997. The conventional wisdom is that the currency crisis in Thailand came without warning and caught financial markets by surprise (Corsetti, Pesenti, and Roubini, 1999, and Halcomb and Marshall, 2000). We investigate whether there were any contrasts between the Austrian and Thai pegs that would have hinted at problems for Thailand prior to July 1997.

The next section discusses alternative exchange rate regimes to put the unilateral peg in context. The third section presents an empirical model of monetary policy to describe the mechanics with which Austria pegged its exchange rate. The fourth section applies the same model to describe Thailand’s monetary policy and the contrast with Austria.

ALTERNATIVE EXCHANGE RATE REGIMES

As a prelude to an analysis of the mechanics of a unilateral exchange rate peg, it is useful to describe the spectrum of alternative exchange rate regimes. In addition to unilateral exchange rate pegs, there are five other exchange rate regimes: a floating rate (including managed floats), multilateral exchange rate pegs, currency boards, dollarization, and currency union. We describe here where the unilateral peg lies along the spectrum. Since the end of the Bretton Woods system of fixed exchange rates in 1973, floating exchange rates have displayed a very high degree of variability without a corresponding increase in the variability of exchange rate fundamentals (Flood and Rose, 1999). Moreover, Hausmann, Panniza, and Stein (1999) have shown that emerging markets in Latin America that have attempted to allow their exchange rates to float have experienced greater interest rate volatility than fixed-rate regimes. For this reason, Calvo and Reinhart (2000) argue that floating exchange rates can have destabilizing effects on emerging markets.

For the next four regimes—all variants of fixed exchange rates—we start with the type of fixed rate that is closest to a float and move along the spectrum from there. In the first three regimes, a home country unilaterally fixes its currency to an “anchor” currency. The unilateral nature of the regime implies that the anchor country is not obligated to assist the home country if its currency comes under speculative attack. In a pegged regime, it is incumbent on the pegging country to set a monetary policy that always appears to currency traders to be consistent with the preannounced conversion rate. The best way to uphold this commitment is to run a monetary policy that is similar to that in the anchor country in terms of inflation rates and credit expansion. A pegging regime is more resistant to speculative attack if banks and other institutions hold an amount of foreign-exchange reserves that is at least as great as the quantity of short-term debt.
that is denominated in foreign currencies. Taiwan, for example, was largely immune to the Asian crisis of 1997-98 due to its large holdings of foreign exchange reserves. Many other emerging markets, however, intend to be net borrowers in foreign currencies, and they attract foreign lending by establishing a peg and promising a stable exchange rate. The best way to keep this promise is to run a monetary policy that closely mimics that of the anchor country.

A currency board differs from a unilateral peg in that the home country no longer sets its own monetary policy. Instead, the size of the monetary base is determined by monetary policy in the anchor country and capital flows. The currency board arrangement leaves no room for policies that are inconsistent with the fixed exchange rate because the only policy is a commitment to adjust the monetary base in tandem with flows of foreign exchange reserves in and out of the central bank. As a consequence, the home country’s central bank can no longer act as a lender of last resort to the domestic banking sector; thus, speculative attacks can take place against banks instead of the currency.

Dollarization represents the unilateral decision to enact two formal changes. The first change is that all local currency in circulation plus vault cash in banks is redeemed for U.S. dollars at some announced conversion rate and is then destroyed. The second change involves transforming all contracts denominated in local currency into contracts in U.S. dollars at the conversion rate. Dollarization, which has recently taken place in Ecuador, has received increasing attention in academic and policy circles.

Exchange rates can also be fixed through multilateral arrangements, although these require more coordination and negotiation than unilateral pegs. Two multilateral systems are multilateral pegs and currency unions. In a multilateral peg, the distinction between the anchor currency and the pegging currency becomes blurred because the participating countries are obligated to take monetary policy measures to defend the exchange rate peg. The prime example of a multilateral peg is the European Monetary System prior to the adoption of a single currency in January 1999. A currency union, in contrast, consists of an agreement to merge several currencies to fix the exchange rates and unify their monetary policymaking permanently. The European Monetary Union, undertaken in 1999, is the most prominent currency union.

**A MODEL OF MONETARY POLICY MECHANICS FOR A UNILATERAL PEG**

In practice, nearly all central banks implement monetary policy by setting a short-term interest rate as a policy instrument. A central bank trying to maintain an exchange rate peg will focus on the interest rate differential between the short-term rate in its domestic currency and the prevailing short-term rate in the anchor currency. If the home currency comes under selling pressure, an increase in the interest rate differential can attract buyers by convincing them that higher domestic interest rates will keep domestic inflation in check, prevent a devaluation, and result in excess returns to the domestic currency relative to the anchor currency. In the long run, the pegging central bank must keep domestic inflation rates close to inflation in the anchor currency. By harmonizing the inflation rates, the central bank prevents the real exchange rate from appreciating to unsustainable levels at the pegged nominal exchange rate. Speculators often bet that central banks that have allowed substantial appreciation of the real exchange rate through relatively high domestic inflation will choose to break the peg and devalue, rather than let the domestic economy stagnate for a prolonged period with a high, uncompetitive real exchange rate.

We preface our presentation of a model of monetary policy mechanics by noting that monetary policy decisions do not strictly obey a particular formula or equation. Nevertheless, central banks do not have to implement in a literal fashion a model of monetary policy for the model to be useful. In fact, central banks often monitor such models themselves because these models provide useful information about the rate of inflation that is likely to result from recent policy decisions.

In our empirical model of monetary policy mechanics, we assume that a pegging central bank adjusts the policy instrument, \( i \) (the interest rate differential), according to a forecast of the relationship between the policy instrument and domestic price inflation, \( \pi \):

\[
\Delta i_t = E_{t+1} \left[ \Delta i_{t+1} + \pi_t \right] - \pi_{0t},
\]

where \( \pi_{0t} \) is the desired inflation rate, which is presumably close to the rate of inflation expected in the anchor currency. Note that this use of a forecast

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1 The term dollarization pertains to adopting the U.S. dollar; however, another major currency could be adopted as well.
to choose the policy instrument setting is analogous
to setting a money-supply instrument, m in logs,
according to a velocity forecast:

\[ \Delta m_t = \Delta y_{0t} - E_{t-1}[\Delta y - \Delta m] , \]

where \( y \) is nominal gross domestic product (GDP)
in logs and \( \Delta y_{0t} \) is the desired rate of nominal GDP
growth at time \( t \). One difference is that, in the latter
formulation, the forecasted quantity, \( \Delta y - \Delta m \), is a
well-known relation (velocity growth), whereas in
the former the forecasted quantity, \( \Delta i + \pi \) is not.\(^2\)

In either case, if policy is set according to the fore-
cast and the forecast is correct on average, then the
desired inflation or nominal GDP growth rate will
be achieved on average.\(^3\)

For a pegging central bank, we add to equation
(1) two feedback terms that indicate the response
to an exchange rate gap and an inflation gap. The
exchange rate gap, \( e - \overline{e} \), is between the actual and
target exchange rate. The inflation gap, \( \pi - \pi^f \), is
between inflation in the home country and the
anchor country:

\[ \Delta i_t = E_{t|t-1} [\Delta i_t + \pi_t] - \pi_{0t} \]
\[ + \lambda_1 (\pi - \pi^f)_{t-1} + \lambda_2 (e - \overline{e})_{t-1} + \varepsilon_t . \]

Not all of these feedback terms will be significant
for both Austria and Thailand, but we estimated
identical models for both countries to highlight the
differences between their policies and not different
models of policy. An error term \( \varepsilon \) is added to equa-
tion (3) to indicate that no central bank follows
interest rate rule perfectly. In practice, we
assume the error term has a Student
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indication (3) to indicate that no central bank follows
error term has a Student
commit this drift. In this model, the implicit target exchange rate that
appears in the exchange-rate gap in equation (3) is
a weighted average of last period’s target and last
period’s actual rate (in logs):

\[ \tilde{\varepsilon}_t = \delta \tilde{\varepsilon}_{t-1} + (1 - \delta) \varepsilon_{t-1} . \]

Gradual rebasing of the target occurs for values of
\( \delta \) less than one. Small shifts in the exchange rate are
gradually accommodated into the target rate. As \( \delta \) decreases from one, the rate of accommodation
increases. Because \( \delta \) is an estimated parameter, the
model infers a path for the exchange rate target that
best explains the central bank’s policy responses
as measured by interest rate adjustments.

**Applying the Model to Austria’s Peg**

In order to use this model as a device to describe
monetary policy mechanics over a relatively long
sample period, it is realistic to allow some of the
parameters to vary across time. Therefore, we make
several parameters subject to two-state Markov
switching, which is a parsimonious way to introduce
variation into the parameter values. For example,
even if Austria were to harmonize its intended infla-
tion rate with Germany’s, we would not expect
Austria’s baseline inflation, \( \pi_0 \), to be constant over
the entire sample period. The German Bundesbank’s
informal inflation target varied between 4.5 and 2
percent (or less) between 1975 and 1994, according
to von Hagen (1995). Thus, we can expect that esti-
mates of \( \pi_0 \) for Austria will switch between two
values that lie roughly in this range. Other param-
eters are not expected to remain absolutely constant
across the entire sample either. For example, the
exchange rate target will sometimes be nearly
constant, \( (\delta = 1) \), whereas at other times it will adjust
to accommodate changes in the prevailing exchange
rate, \( (\delta < 1) \). Markov switching is a method that lets
economists use the data and model to infer when
parameter shifts occurred, rather than impose their
own judgment. Also subject to switching are the
feedback parameters, \( \lambda_1 \) and \( \lambda_2 \), and the variance,
\( \sigma^2 \). We use three different binary Markov state vari-
ables, \( S_i \), \( S_2 \), and \( S_3 \), with transition probabilities,
\( p_i \), \( q_i \), \( i = 1, 2, 3 \), where \( p_i = \text{Prob}(S_i = 0|S_{i-1} = 0) \)
and \( q_i = \text{Prob}(S_i = 1|S_{i-1} = 1) \).\(^4\) The first state vari-
able governs switching in \( \pi_0 \). The second governs
switching in the feedback parameters \( \lambda_1 \), \( \lambda_2 \), and \( \delta \).

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\(^2\) An equivalent set-up to equation (1) would be to forecast \( \Delta i + \Delta \pi \) to
\( \text{change in inflation as } \pi_{0t} - \pi_{0t-1} . \)

\(^3\) Dueker and Fischer (1998) discuss the forecasting of the ratio
between the nominal target variable and the policy instrument.

\(^4\) Technical details regarding the estimation procedure are in the
Appendix and Dueker and Fischer (1996).
The third governs switching in $\sigma^2$, the variance of the error term. A more parsimonious model would tie all of these parameters to a single state variable, but it seems too restrictive to force the inflation target to move in tandem with the rebasing of the exchange rate target.

The data used to estimate the model are short-term interest rates and inflation rates for Austria and Germany, as well as the exchange rate between the Austrian schilling and the Deutsche mark. We use the three-month repurchase rates for Austria and Germany, which are the most representative short-term interest rates. The consumer price index (CPI) is the inflation measure. Our sample consists of quarterly data from 1972 to the end of 1994. On January 1, 1995, Austria officially entered the Exchange Rate Mechanism of the European Monetary System, whereupon the exchange rate became part of a multilateral peg.\(^5\) Discussion of the construction of the forecasts, $E_{t-1}[\Delta_i + \pi^*_i]$, and the likelihood function is included in the Appendix.

Parameter estimates for Austria from 1972:Q2 through 1994:Q3 are in Table 1, where subscripts $a$ and $b$ denote the pair of values of parameters subject to Markov switching. The $a$ values correspond with the $p$ transition probabilities, and the $b$ values correspond with the $q$ transition probabilities. Parameter values reported as equal to either zero or one converged arbitrarily close to those values and were not restricted in the estimation.

The estimates of Austria’s baseline inflation rates, $\pi_{0a,b} = (1.74, 3.49)$, from Table 1 are quite close to the range of Germany’s informal inflation targets of 4.5 to 2 percent or less.\(^6\) The unconditional value of Austria’s $\pi_0$ is 2.89. We call $\pi_0$ a baseline inflation rate because it would be the inflation target if both the exchange rate gap and the inflation gap were zero. To assess further whether Austrian monetary policy was aiming at a common rate of inflation with Germany, we estimated equation (3) for Germany, with the feedback coefficients $\lambda_1$ and $\lambda_2$ set to zero.

The estimates of $\pi_{0a,b}$ for Germany are $(0.71, 3.50)$, with an unconditional value of 2.86, which is extremely close to Austria’s 2.89. Thus, Austria’s monetary policymakers revealed through their interest rate instrument settings a preference for the same inflation rate as that of Germany, even in the absence of feedback from the exchange rate and inflation gaps.

Figure 1 shows a plot of the probability-weighted values of $\pi_0$ for Austria and Germany and shows a high degree of correspondence between the two. Austria’s period-by-period inflation target, conditional on the inflation and exchange rate gaps, equals $\pi_{0t} - \lambda_{1t}(\pi - \pi_{0t-1}) - \lambda_{2t}(e - e_{t-1})$.

\(^5\) From 1974 to 1995, the Austrian National Bank unilaterally pegged the Austrian schilling to the Deutsche mark. This policy was known as the “hard-currency policy.” Hochreiter and Winckler (1995) discuss this policy regime in detail.

\(^6\) These results are presented in detail in Dueker and Fischer (2000).
Since $\lambda_1$ equals zero in both states, Austria’s monetary policy took feedback from the exchange rate only. One conclusion we can draw is that strong feedback from the inflation gap is not necessary for a peg to succeed, provided that the pegging country has chosen the same baseline inflation rates, $\pi_0$, as the anchor country.

Figure 2 shows Austria’s period-by-period inflation target plotted against the actual rate of inflation in Germany calculated as the change in the CPI in the four most recent quarters. This chart suggests that Austria imported inflation from Germany during the two peaks in German inflation, the first in 1975 and the second in 1982. German inflation influenced Austrian monetary policy through the exchange rate because $e - \bar{e}$ tended to be negative when German inflation was high. Figure 3 presents the model-implied exchange rate target, $\bar{e}$, and the actual exchange rate. In studying Figure 3, one must keep the scale in mind because the schilling fluctuated in a relatively narrow band throughout these 20 years. For most of the period, the exchange rate gap was negligible; therefore, Austrian monetary policy focused on keeping its inflation rate close to $\pi_0$, which Austrian policymakers had chosen to be close to Germany’s inflation target. Nevertheless, the magnitude and significance of the feedback coefficients on exchange rate gaps, $\lambda_2$ in Table 1, indicate that Austrian monetary policy remained poised to act decisively to close any exchange rate gap that developed.

The Model of Peg Mechanics Applied to Thailand

Among the East Asian countries that were forced to break an exchange rate peg between 1997 and 1998, Thailand was the first, and perhaps the most surprising, to devalue. Prior to 1997, Thailand had maintained one of the tightest and most long-standing pegs in Asia. To understand the mechanics behind Thailand’s peg of the Thai baht to the U.S. dollar, we estimate equation (3) for Thailand and compare the results with Austria. As with Austria, we used the three-month interest rate and the CPI along with the exchange rate. For Thailand, however, we used monthly data from January 1990 through June 1997, one month before the peg was broken.

Table 2 reports the parameter estimates: these show that Thailand’s baseline inflation rate, $\pi_0T$, had an unconditional probability-weighted value of 6.5, which is well above the average level of U.S. inflation for that period, 3.1 percent. Hence the only way that Thailand’s period-by-period inflation target could remain close to the U.S. rate would be through feedback from the inflation and exchange rate gaps. In contrast, Austria’s baseline inflation rate closely matched the corresponding rate in Germany. Figure 4 shows that Thailand’s inflation rate consistently

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7 In the graph the rates appear in levels, but they enter equation (3) in logarithms $\times 100$. 
exceeded the inflation rate in the United States, but by less than 3.4 percent (6.5 – 3.1), because of feedback from the inflation gap. Parameters $p_2$ and $q_2$ are the transition probabilities for switching in the feedback coefficients, $\lambda_1$ and $\gamma_2$, and both show very little persistence. In fact, since $p_2 + q_2 < 1$, the feedback coefficients show negative serial correlation, which implies oscillatory behavior in the period-by-period inflation target, 

$$\pi_{t-1} = \lambda_{1a} (\pi - \pi_{US}^{t-1}) - \lambda_{2b} (e - \bar{e})_{t-1}. \tag{5}$$

For Thailand, the feedback coefficients $\lambda_{1b}$ and $\lambda_{2b}$ imply strong responses to inflation and exchange rate gaps. For Austria, the feedback coefficients display no serial correlation—either positive or negative—because $p_2 + q_2$ is essentially equal to one; moreover, feedback from the gaps does not play an important role in determining Austria’s interest rate.

Figure 5 shows that—after 1995 especially—Thailand’s period-by-period inflation target, which is conditional on feedback from the gaps, appears to inherit negative serial correlation from switching in the feedback coefficients. Figure 6 plots the posterior probability of the high-feedback state and confirms that the fluctuation in the probability from month to month went from a relatively narrow range, between 50 percent and 60 percent prior to mid-1995, to a much greater range thereafter. The discussion that follows centers on why Thailand’s policy feedback coefficients became more volatile starting in mid-1995.

The exchange value of the U.S. dollar—to which the baht was pegged—reached a record low in May 1995 against the Japanese yen, at which time the dollar was also weak against other major currencies. Prior to May 1995, the dollar had depreciated consistently against the yen since early 1990 (as shown in Figure 7). Since Japan is both a major trading partner and a rival exporter with Thailand, the baht-dollar peg was able to sustain a rising real exchange rate with the dollar during the period that the yen was appreciating against the dollar. In May 1995, however, the dollar-yen exchange rate peaked and the real exchange value of the yen began to depreciate against the dollar. To remain competitive in international markets, Thailand felt compelled at this juncture to prevent further appreciation of the real exchange value of the baht relative to the dollar. Clearly, it would have been difficult for Thailand if the real exchange value of the baht had been expected to continue to increase relative to the

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8 The posterior probability is the probability of a state at time $t$ conditional on the data up to and including time $t$.

9 The real exchange rate rises for Thailand if the inflation rate is greater in Thailand than in the United States and the nominal exchange rate (expressed in baht per dollar) does not increase by an equal magnitude.
dollar at a time when the real exchange value of
the dollar was rising relative to the world’s other
major currencies.

One key aspect of the credibility of an exchange
rate peg is whether the market believes that the
pegging country’s economy remains competitive
internationally, given any appreciation of its real
exchange rate that has taken place during the peg.
Thailand’s appreciating real exchange value relative
to the dollar may have appeared sustainable during
a period when many of the world’s other major
currencies were appreciating relative to the dollar,
but not when this course reversed. For this reason,
it is not surprising that Figure 5 shows that Thailand’s
period-by-period inflation target was kept centered
on a mean closer to the U.S. inflation rate after mid-
1995. An obvious question, however, is why the
inflation target was so volatile around this lower
mean. The answer probably lies in the extreme
inflows of foreign capital that Thailand was receiving
at the time. On one hand, raising the short-term
interest rate helped to reduce domestic demand
and inflation. On the other hand, high interest rates
helped spur additional flows of foreign capital to
Thailand in search of high returns. In fact, the
amount of foreign capital that flowed to Thailand
in 1996 was massive, at a level equal to 13 percent
of GDP (Grenville, 2000, p. 6). The tension between
wanting to control domestic demand and inflation
in the short run and worrying about the conse-
quences of the huge capital inflows could explain
the apparent stop-go behavior of Thailand’s monetary
policy after mid-1995. Such a balancing act—
the rapid fluctuation of the feedback coefficients
after 1995, shown in Figure 6—was not a sustainable
policy for the long run. By July 1997, speculators
had broken the exchange rate peg. Halcomb and
Marshall (2000) review evidence that Thailand’s

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**Figure 5**

**Thailand’s Feedback Rule**

![Thailand’s Feedback Rule](image)

**Figure 6**

**Thailand: Posterior Probability of the High-Feedback Coefficients on the Gaps**

![Thailand: Posterior Probability of the High-Feedback Coefficients on the Gaps](image)

**Figure 7**

**Yen/U.S. Dollar Exchange Rate**

![Yen/U.S. Dollar Exchange Rate](image)
devaluation of the baht in July 1997 was not widely anticipated in financial markets. They observe that the timing of a currency crisis can be difficult to predict, even if one knows that a peg is not on solid footing for the long run.

In the face of such massive capital inflows, it seems apparent in hindsight that Thailand probably should not have maintained such a hard peg. Instead, the monetary policy authority could have signaled by mid-1995 a greater degree of flexibility with respect to adjusting the peg. Indeed, the Bank of Thailand now practices inflation targeting with a floating exchange rate (Sonakul, 2000, p. 2).

Figure 8 shows the baht-dollar exchange rate along with the model-implied target rate, $e$. This chart suggests that the Bank of Thailand allowed the baht to depreciate by about 4 percent in the 18 months prior to July 1997. Clearly this rate of depreciation was not enough to counteract the large interest rate differential shown in Figure 9. The size of the interest rate differential between Thailand and the United States in the early part of 1995 suggested that the Bank of Thailand might have signaled a willingness to let the baht depreciate at a rate of about 5 percent per year. Such a rate of expected depreciation also might have helped alleviate the capital inflows by discouraging domestic borrowers from taking dollar-denominated loans. Instead, the Bank of Thailand chose to defend the peg by squeezing speculators who tried to take short positions in baht by imposing high interest rates and pressure on domestic banks not to lend to off-shore currency traders (Halcomb and Marshall, 2000).

**SUMMARY AND CONCLUSIONS**

Our empirical results for Austria’s successful exchange rate peg highlight the importance the Austrian National Bank placed on consistently maintaining Austria’s inflation rate close to that of Germany. In so doing, Austria prevented the real exchange value of the schilling vis-a-vis the Deutsche mark from drifting far from its initial value. Furthermore, the Austrian economy had enough in common with the German economy that the Austrian National Bank was willing to let the real exchange value of the schilling experience the vicissitudes in the real exchange value of the Deutsche mark against other major currencies.

One lesson for pegging countries is that they ought to behave like assiduous inflation targeters even when there is no pressure on the exchange rate. The key is that the inflation target should be the same inflation target used in the anchor country because the nominal exchange rate can no longer move to correct an overvalued real exchange rate. Feedback from the inflation and exchange rate gaps did not appear to play an important role in Austria’s successful peg, given that Austria followed Germany’s infla-
tion target closely even before gaps developed. A second lesson is to take care in choosing an anchor currency because the major currencies experience wide swings against one another. It makes no sense to tie one’s currency to the dollar if the fluctuations in the exchange value of the dollar against other major currencies are difficult to withstand.

Both of these lessons appear to apply to Thailand’s peg to the U.S. dollar. The Bank of Thailand allowed the domestic inflation rate to exceed the U.S. inflation rate prior to mid-1995, based on the depreciation of the U.S. dollar against other major currencies, principally the Japanese yen. In fact, the estimates of Thailand’s baseline inflation rate were more than twice the average U.S. inflation rate. If the Bank of Thailand truly had a long-term commitment to pegging its currency to the dollar, it would not have tried to take advantage of the depreciation in the dollar against the yen by inflating. This policy led to trouble when the U.S. dollar began to appreciate against the yen in the second half of 1995. At this point, Thailand’s policy response to the inflation gap between Thailand and the United States was strong, but it was not implemented consistently. The model estimates reveal unstable, oscillatory behavior in the feedback from the inflation gap, probably due to the tension between the desire for high interest rates to control inflation and concern for the size of the capital inflows that high interest rates were attracting. In these circumstances, it would have been exceedingly difficult for inflation in Thailand to undershoot the U.S. inflation rate by a significant margin. The Bank of Thailand might have fared better by announcing gradual depreciation of the nominal exchange rate, starting in mid-1995, before speculators began to apply their own pressure. Since the crisis in 1997-98, the Bank of Thailand has announced a new inflation-targeting regime in place of an exchange rate peg. The Bank of Thailand believes that the new regime will be less prone to boom and bust cycles than was the peg to the dollar (Sonakul, 2000).

References


about the relationships among the variables. Moreover, the time-varying structure of the forecasts allows it to adapt to structural breaks in the relationships between the dependent and explanatory variables.

The maximum-likelihood estimates reported in Tables 1 and 2 are the result of estimating the following density function, which includes three Markov state variables denoted \( S_1, S_2, \) and \( S_3, \) where \( Y_{t-1} \) is all information available through time \( t-1: \)

\[
\text{Prob}(S_1 = i, S_2 = j, S_3 = k | Y_{t-1}) L_t^{(i,j,k)}
\]

The Student \( t \) densities are

\[
\ln L_t^{(i,j,k)} = \ln \Gamma(0.5(n + 1)) - \ln \Gamma(0.5n) - 0.5 \ln \left( \pi n \sigma^2 S_{3,k} \right) - 0.5(n + 1) \ln \left( 1 + \frac{\bar{e}^2_{S_1 = i, S_2 = j}}{n \sigma^2 S_{3,k}} \right),
\]

and \( \Gamma \) is the gamma function.

**Appendix**

The forecasts for equation (3) are taken from a model that allows for two types of uncertainty. The first arises from heteroscedasticity in the error terms. This is modeled by a Markov switching process, which tries to match the persistence of periods of high and low volatility in the data. The second source of uncertainty arises as economic agents are obliged to infer unknown or changing regression coefficients.

The model generating the forecasts is

\[
\left( \Delta i_t + \pi_t \right) = \\
\beta_{3i} + \beta_{ii} \Delta i_{t-1} + \beta_{ii} \pi_{t-1} + \beta_{iii} \Delta e_{t-1} + u_t,
\]

\( u_t \sim \text{Normal}(0, h_t). \)

\( h_t = v_0^2 + (v_1^2 - v_0^2) R_t, \)

where \( R_t \) is 0 or 1

Probability \( (R_t = 0 | R_{t-1} = 0) = r_1 \)

Probability \( (R_t = 1 | R_{t-1} = 1) = r_2. \)

Variable \( i \) is the interest rate differential, \( \pi \) is consumer price inflation, and \( e \) is the exchange rate in logs.

The time-varying coefficients assume that the state variables, \( \beta_t, \) follow a random walk process:

\[
\beta_t = \beta_{t-1} + \nu_t
\]

\( \nu_t \sim \text{Normal}(0, Q). \)

The random walk assumption suggests that agents need new information before changing their views about the relationships among the variables. Moreover, the time-varying structure of the forecasts allows it to adapt to structural breaks in the relationships between the dependent and explanatory variables.

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\]

The Student \( t \) densities are

\[
\ln L_t^{(i,j,k)} = \ln \Gamma(0.5(n + 1)) - \ln \Gamma(0.5n) - 0.5 \ln \left( \pi n \sigma^2 S_{3,k} \right) - 0.5(n + 1) \ln \left( 1 + \frac{\bar{e}^2_{S_1 = i, S_2 = j}}{n \sigma^2 S_{3,k}} \right),
\]

and \( \Gamma \) is the gamma function.