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Impact of Exchange Rate Regimes on Financial Stability in Developed and Developing Economies

[1]Amjad Ali, [2]Rana Muhammad Adil Anjum, [3]Muhammad Irfan

Amjad Ali
Lahore School of Accountancy and Finance, University of Lahore, Pakistan
Rana Muhammad Adil Anjum
Lahore School of Accountancy and Finance, University of Lahore, Pakistan
Muhammad Irfan
Sarhad University of Science and Information Technology, Peshawar, Pakistan

Abstract

This study investigates the impact of different exchange rate regimes on financial stability across both developed and developing countries from 2005 and 2023. Exchange rate policy is a critical component of a nation's macroeconomic framework, influencing key financial indicators and institutional dynamics. Employing a mixed-methods approach, data sources are the International Monetary Fund, World Bank, and Bank for International Settlements. The regression analysis reveals that developed economies tend to perform better under floating exchange rate regimes, owing to stronger institutional frameworks and greater policy flexibility. Furthermore, the study highlights the significant influence of regime type on financial indicators such as inflation, foreign reserves, and current account balances. It underscores the importance of institutional strength, credible monetary policy, and effective governance in the successful implementation of exchange rate regimes. These findings offer valuable insights for policymakers in tailoring exchange rate strategies to national economic contexts. The study recommends that countries align their regime choices with local economic conditions, reinforced by disciplined macroeconomic management and enhanced transparency.

Keywords: *Exchange Rate Regimes, Financial Stability, Monetary Policy, Inflation Volatility*

Introduction

A country's macroeconomic framework significantly depends on its choice of exchange rate regime, which influences both international trade and the stability of its financial system. The management of currency value relative to foreign currencies is essential to a country's ability to withstand economic shocks, whether domestic or international. Over time, nations have alternated between fixed exchange rate regimes, flexible exchange rate regimes, and hybrid systems that combine elements of both. These regimes involve not only economic policy choices but also depend heavily on the strength of a country's legal institutions, the credibility of its government, its monetary governance, and the extent of its integration into global markets (Bank for International Settlements, 2019). In the aftermath of the global financial crisis of 2008, ensuring the resilience of financial systems and markets against external shocks has become a top priority for governments. Exchange rate policies impact domestic price levels, interest rates, inflation expectations, and investor confidence—factors that are foundational to financial sector stability. Moreover, a country's approach to managing its exchange rate plays a critical role in regulating international capital flows, managing external debt, and shaping trade competitiveness strategies.

In developing countries, poorly managed exchange rate regimes often lead to currency crises, balance sheet mismatches, and capital flight due to loss of investor confidence (Feldstein, 2002). In contrast, well-structured and credible regimes can shield economies from external vulnerabilities and foster an environment conducive to long-term investment. For countries with significant exposure to foreign currency obligations, effective coordination between fiscal policy and exchange rate management is imperative. Institutional effectiveness—characterized by rule clarity, enforcement capability, and policy adaptability—further enhances financial stability and long-term growth (Arner, 2007). The interaction between exchange rate flexibility and monetary policy independence is particularly critical during periods of economic distress and recovery. Advanced economies often enjoy greater autonomy in monetary policy due to their reliance on floating exchange rate regimes (Tandfonline, 2022). However, for many developing countries, this same flexibility can introduce volatility, especially in contexts where institutional frameworks are weak and inflation expectations are unanchored.

The debate over the most appropriate exchange rate regime remains unresolved. Ghosh et al. (2003) and Reinhart and Rogoff (2004) emphasize that the optimal choice varies among sovereigns. The effectiveness of any given regime depends on several structural factors, including the credibility and strength of institutions, soundness of fiscal management, the breadth and depth of financial markets, and the extent of exposure to external shocks. Emerging financial developments, such as the proliferation of digital currencies and the rise of algorithmic trading, have added layers of complexity to exchange rate management (Obstfeld and Rogoff, 1995). Global financial integration has intensified the pressure on countries to adapt their exchange rate policies, as capital mobility forces even flexible exchange rate economies to consider the preferences and expectations of international investors (Dornbusch, 2016; Diaz & Collin, 2025). As a pragmatic response, some countries adopt managed float systems commonly referred to as "dirty floats," which involve occasional intervention to smooth extreme currency fluctuations while allowing for some market-driven flexibility. The advent of digital currencies and decentralized finance presents new challenges, as these innovations often operate beyond the direct control of central banks and introduce unpredictable dynamics into capital flows (Raskin and Yermack, 2018; Iqbal & Hayat, 2025). In light of these disruptions, countries must prioritize institutional reform and cultivate credible policy commitments to bolster resilience.

Demographic shifts and technological advancements are reshaping economic behavior and, consequently, the responsiveness of exchange rates. For instance, the ageing population in developed economies affects patterns of savings and investment, while rapid technological adoption in emerging markets influences trade competitiveness. These dynamics highlight the importance of maintaining exchange rate policy flexibility to accommodate evolving economic conditions. Enhanced transparency, clear communication strategies, and stronger regional coordination are key to mitigating the contagion of external shocks and reinforcing economic resilience. This research investigates how the impact of exchange rate regimes on financial stability differs across levels of economic development. It evaluates both core macroeconomic indicators and institutional performance metrics to explain the divergence between developed and developing countries.

Literature Review

International economics has long examined the impact of exchange rate regimes—fixed, floating, or hybrid—on financial stability. Fixed exchange rate regimes can anchor inflation and reduce currency risk, promoting coordination among households, firms, and financial markets (Ghosh, 2009). Pegging to a stable currency often brings greater stability, while floating regimes allow currencies to adjust to market forces, fostering resilience when financial institutions are robust (Bank for International Settlements, 2019). However, floating regimes can also increase volatility, potentially discouraging investment and trade. Thus, choosing an exchange rate regime requires balancing the stability of fixed arrangements with the flexibility of floating systems, particularly during periods of economic stress.

In less developed economies, where financial systems are weaker, exchange rate regimes have pronounced effects. Historically, fixed regimes have been used to enforce discipline and contain inflation (Bleaney and Francisco, 2005). Yet, without sound fiscal policy and strong fundamentals, these regimes may amplify vulnerabilities, as seen during the 1997 Asian financial crisis (Bank for International Settlements, 2019). Limited reserves and fragile banks often undermine the sustainability of fixed pegs, while flexible regimes, although better at absorbing shocks, can deter investment if volatility is not well managed.

Developed economies, supported by deep financial systems, more easily absorb exchange rate fluctuations. Countries like the U.S., U.K., and Japan have maintained floating regimes without major disruptions (Cambridge Core, 2025). Currency unions, such as the eurozone, present unique challenges, highlighting the need for fiscal integration and strong institutional frameworks. Long-term regime success in advanced economies depends on effective fiscal governance, strong institutions, and mature markets. Disciplined fiscal management and credible institutions are essential for both fixed and floating systems, while economic openness shapes the optimal choice (Cambridge Core, 2025; Tandfonline, 2022; Audi, 2025).

Recent literature suggests that intermediate regimes—combining fixed and floating features—can offer a balance of stability and flexibility (Tandfonline, 2022; Irfan & Ahmad, 2025). These systems allow for limited currency adjustments to absorb shocks but require high institutional quality and clear communication to remain credible. Without these, intermediate regimes are vulnerable to speculative pressures. Many emerging markets are cautious about fully floating rates, preferring managed flexibility to avoid inflation and instability.

Hybrid regimes must be tailored to each country's macroeconomic and institutional context (Rocha Menocal et al., 2008; Cizakca, 2024; Nwosu & Folarin, 2025). Many nations intervene in currency markets, even under floating regimes, to control volatility. Such intervention can delay structural reforms and create risks if market participants doubt policy consistency. Thus, regime design must weigh institutional credibility, market expectations, and macroeconomic coordination. Exchange rate regimes also influence capital flows. Fixed regimes often attract capital by minimizing currency risk, but loss of confidence can trigger rapid outflows and crises (Obstfeld and Rogoff, 1995). Floating regimes offer automatic stabilizers, but require strong institutional safeguards to prevent macroeconomic instability (Frankel, 2003). Empirical studies show that intermediate regimes like crawling pegs and managed floats can yield stable macroeconomic outcomes when fiscal and monetary policies are coordinated (Levy-Yeyati and Sturzenegger, 2005).

Globalization and technological change have increased the complexity of managing exchange rate regimes. Central banks now face constraints in pursuing both monetary independence and exchange rate stability as financial openness increases (Aizenman et al., 2010; Sheikh & Ahmad, 2020; Nasir, 2022; Sadashiv, 2023). Meanwhile, innovations such as cryptocurrencies, central bank digital currencies, and algorithmic trading demand adaptive exchange rate management (Bank for International Settlements, 2021). The rise of digital platforms and speculative activity outside traditional regulation highlights the need for modern regulatory frameworks and strong institutional capacity. To stay effective, exchange rate policies must evolve alongside financial innovation, leveraging new opportunities while mitigating emerging risks.

The literature reveals persistent gaps regarding the nuanced effects of different regimes—fixed, floating, and hybrid across varied macroeconomic and institutional contexts. Much of the foundational work has highlighted the stabilizing potential of fixed exchange rates and the flexibility of floating systems (Ghosh, 2009; Ali & Rehman, 2015), yet often fails to account for the growing complexity faced by developing economies with underdeveloped financial systems and exposure to global capital flows (Bleaney and Francisco, 2005; Obstfeld and Rogoff, 1995). Recent crises, such as the Asian financial crisis, underscore that rigid pegs, without supportive fiscal discipline and institutional strength, can amplify systemic risk rather than mitigate it (Bank for International Settlements, 2019). While developed economies with advanced institutions can absorb exchange rate shocks more effectively (Ali & Zulfiqar, 2018; Sabra, 2022; Khalid & Abdul, 2025; Fateh & Poulin, 2025), comparative studies on hybrid and intermediate regimes remain limited, particularly regarding their long-term resilience, policy credibility, and adaptability in an era of financial globalization and rapid technological change (Levy-Yeyati and Sturzenegger, 2005; Aizenman et al., 2010; Ali, 2015; Willy, 2018; Marc et al., 2021; Ali & Audi, 2023; Hanvoravongchai & Paweenawat, 2025). Furthermore, the intersection of exchange rate policy with digital financial innovation—such as cryptocurrencies and algorithmic trading—has yet to be systematically addressed, leaving questions about the adequacy of traditional frameworks in safeguarding financial stability in the digital age (Kumar & Wu, 2025; Frankel, 2003). This study aims to address these gaps by exploring how evolving exchange rate regimes interact with institutional quality, fiscal discipline, and emerging financial technologies to influence financial stability across both developed and developing economies.

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Theoretical Links

The theoretical foundation for this study is grounded in the Mundell-Fleming model and the Trilemma of International Finance, which outline the trade-offs policymakers face when managing exchange rate systems. The Trilemma, or Impossible Trinity (Obstfeld & Rogoff, 1995; Aizenman et al., 2010), states that no country can simultaneously maintain a fixed exchange rate, full capital mobility, and independent monetary policy; only two of these objectives can be achieved at once. For instance, a country with a fixed exchange rate and open capital markets must forgo monetary autonomy. These choices become especially critical during periods of economic stress. The effectiveness of any exchange rate regime depends on domestic institutional strength, credible monetary policy, and macroeconomic conditions (Ghosh et al., 2003; Reinhart & Rogoff, 2004). Strong legal frameworks, transparent governance, and reliable central banks support the success of flexible regimes. In contrast, less developed institutions may benefit from fixed regimes, which can help anchor inflation and promote stability. This analysis is also informed by optimal currency area theory, which identifies the conditions favoring fixed regimes or monetary unions: high economic integration, labor mobility, fiscal flexibility, and synchronized business cycles (Husain et al., 2005; Levy-Yeyati & Sturzenegger, 2005). Conversely, in economies with sectoral diversity, volatile capital flows, or frequent shocks, flexible exchange rates can buffer external disturbances more effectively. The model is specified as follows:

$$FSIit = \alpha + \beta_1 EXR_{it} + \beta_2 GDP_{pcit} + \beta_3 INF_{it} + \beta_4 OPEN_{it} + \beta_5 POLSTAB_{it} + \mathcal{E}_{it}$$

where

FSIit denotes the financial stability index for country i at time t. Financial stability is assessed using both macroeconomic and financial market indicators, including external balance metrics (e.g., current account balance as a percentage of GDP), monetary and price stability indicators (e.g., inflation volatility, exchange rate volatility), resilience measures (e.g., international reserves adequacy, capital account openness), and banking sector health indicators (e.g., non-performing loans, credit-to-GDP ratio). An index composed of multiple indicators is used to capture financial stability in this context. The FSI incorporates dimensions of monetary stability, external stability, and banking sector health. The index is normalised and standardised using principal component analysis (PCA), a conventional method for constructing economic composite indices (Kaminsky and Reinhart, 1999). The exchange rate regime (EXRit)—classified as floating, intermediate, or fixed—is represented using dummy variables as the independent variable. To isolate the impact of regime type, the analysis includes GDP per capita, trade openness, inflation rate, central bank independence (using Cukierman's index), and the Worldwide Governance Indicators. These controls help mitigate potential bias in the link between exchange rate regimes and financial stability arising from institutional differences (Husain et al., 2005). Specifically, control variables include GDP per capita (GDPpcit), inflation (INFit), trade openness (OPENit), and political stability (POLSTABit). Their inclusion enables a more accurate estimation of the relationship between exchange rate regime and financial stability by accounting for major macroeconomic influences. GDP per capita reflects a country's development level and may influence how a regime functions, revealing macroeconomic discipline and policy effectiveness. Trade openness illustrates integration into the global economy and sensitivity to external shocks and exchange rate volatility. Political stability, in turn, supports effective institutions and sound policy, both critical to exchange rate management.

Research Methodology

This study adopts a comprehensive research design employing both quantitative and qualitative methods to assess the impact of exchange rate policies on financial stability across a diverse set of developed and developing countries. The structure of the research design is shaped by the dual objective of analyzing financial data quantitatively while contextualizing these findings using policy insights, institutional quality, and broader macroeconomic factors. A purposive sampling approach ensures geographic and economic diversity, with countries from both developed and developing regions included to facilitate meaningful cross-country and cross-regime comparisons.

The study period spans from 2005 to 2023, encompassing several major global economic events, such as the Global Financial Crisis in 2008, the European sovereign debt crisis in 2012, and the COVID-19 pandemic in 2020. The inclusion of these periods allows for the analysis of exchange rate regime responses under both normal conditions and during economic shocks, enhancing the robustness and temporal relevance of the findings. This longitudinal approach is consistent with best practices in economic research, which emphasize the importance of observing long-term trends and the effects of systemic events.

The sample includes twenty-four countries, with equal representation from developed and developing economies. Developed economies represented in the study include the United States, the United Kingdom, Germany, Japan, and Canada, while developing countries include India, Brazil, Pakistan, Nigeria, and Indonesia. The selected countries exhibit a range of exchange rate regimes, from highly flexible to rigidly fixed, enabling a nuanced cross-regime analysis. Country selection is grounded in prior economic literature, focusing on nations with significant macroeconomic influence and pronounced policy frameworks (Reinhart & Rogoff, 2004).

Exchange rate regime classification is based on de facto regime analysis, as reported in the International Monetary Fund's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). This classification reflects the actual operational behavior of governments, rather than the legal or stated policy (de jure), thus providing greater accuracy and policy relevance (Ghosh et al., 2003). Countries are categorized into three principal groups: floating regimes, intermediate (managed float) regimes, and fixed or pegged regimes. Each regime type is represented within both developed and developing country categories, allowing for the generalization of results and the detection of differences arising from varying levels of development and institutional strength.

Data collection for this research is based predominantly on secondary sources, utilizing authoritative international databases. Key financial and macroeconomic indicators, such as current account balances, inflation volatility, interest rate volatility, foreign exchange reserves, and capital flows, are drawn from the International Monetary Fund's International Financial Statistics, the World Bank's World Development Indicators, and the Bank for International Settlements. Exchange rate regime data is obtained from the International Monetary Fund's publications, supplemented by central bank records and leading academic studies. Qualitative insights are garnered from policy documents, central bank reports, and macroprudential strategy papers issued by organizations such as the Bank for International Settlements and the Financial Stability Board. To reduce volatility and better capture underlying relationships, a five-year moving average is applied to the time-series data, following the methodology used by Levy-Yeyati and Sturzenegger (2005).

The analytical strategy begins with descriptive statistics to examine the distributional properties of the variables, followed by Pearson correlation analysis to explore the bivariate relationships between exchange rate regimes and financial stability indicators. Multivariate regression techniques are then employed, starting with Ordinary Least Squares regressions. Recognizing the potential for endogeneity between regime selection and financial stability outcomes, the study employs Instrumental Variable regression using the Generalized Method of Moments estimator. Instruments include historical currency values and institutional quality indicators, as recommended in Klein and Shambaugh (2010), thereby addressing potential biases in regime selection and ensuring more credible causal inference. Through this mixed-methods approach, the research rigorously investigates the relationship between exchange rate policy and financial stability, accounting for the influence of institutional and macroeconomic context.

Empirical Results and Findings

Table 1 presents the correlation matrix for the theoretical model, revealing several important relationships among the variables under consideration. Most notably, the Financial Stability Index is strongly and positively correlated with both gross domestic product per capita (0.64) and political stability (0.70). These robust associations highlight the centrality of economic development and high institutional quality in promoting a stable financial system—a conclusion well-supported in the economic literature (Beck, Demirgüç-Kunt, & Levine, 2009; Acemoglu & Robinson, 2012). The analysis also uncovers a moderate positive correlation between the Financial Stability Index and the Exchange Rate Regime (0.48), suggesting that more flexible or well-governed exchange rate systems are linked to improved financial system stability, perhaps by allowing countries to better absorb external shocks and maintain macroeconomic balance (Obstfeld, Shambaugh, & Taylor, 2010).

Furthermore, the negative correlation between the financial stability index and inflation (–0.42) indicates that higher inflation rates tend to erode financial stability, aligning with the consensus that price stability is a cornerstone of sound financial systems (Fry et al., 1996). The moderate positive association between trade openness and the financial stability index (0.36) points to the potential for international economic integration to enhance resilience against financial disturbances, although the relationship is not as strong as those with institutional or macroeconomic variables. This underscores the multi-dimensional nature of financial stability, which is supported by a combination of robust economic performance, effective governance, prudent macroeconomic management, and measured engagement in global trade. The interrelationships in Table 1 are consistent with both empirical findings and theoretical frameworks that stress the importance of "deep" institutions and prudent policy environments for long-term financial and economic stability (La Porta et al., 1997; Acemoglu et al., 2003).

Table 1: Correlation Matrix

Variables	FSI	EXR	GDPpc	INF	OPEN	POLSTAB
FSI	1					
EXR (Regime)	0.48	1				
GDPpc	0.64	0.39	1			
INF (Inflation)	-0.42	-0.28	-0.53	1		
OPEN (Openness)	0.36	0.3	0.52	-0.44	1	

POLSTAB	0.7	0.45	0.62	-0.47	0.41	1

Table 2 presents regression results for the determinants of financial stability in the full sample of countries, offering important empirical evidence on how macroeconomic and institutional variables shape the resilience of national financial systems. The analysis reveals that the exchange rate regime is a statistically significant predictor of financial stability, with a positive coefficient (0.108) indicating that countries with more flexible exchange rate arrangements tend to achieve higher levels of financial stability. This finding supports the view that floating or well-managed exchange rate systems, especially when coupled with credible institutions, enhance a country's capacity to absorb external shocks and maintain financial sector confidence (Levy-Yeyati & Sturzenegger, 2005). Gross domestic product per capita also exhibits a positive and significant effect (0.000025), reinforcing the critical role of sustained economic development in underpinning financial system robustness. This is consistent with the literature emphasizing that wealthier economies typically have deeper financial markets and more effective regulatory structures (Beck et al., 2009). By contrast, inflation exerts a negative impact (–0.014), affirming the classic macroeconomic principle that persistent price instability undermines the credibility and functioning of financial systems (Fry et al., 1996). Of all the factors considered, political stability stands out as the most influential determinant, with a strong positive coefficient (0.194). This underscores the importance of institutional quality and effective governance as the foundations for a stable financial environment, echoing the extensive empirical evidence linking sound political institutions to better economic and financial outcomes (Acemoglu & Robinson, 2012). The model demonstrates strong explanatory power, with an R^2 of 0.69, indicating that nearly seventy percent of the variation in financial stability across countries is accounted for by the included variables. Developed countries with floating exchange rates benefit from the policy flexibility needed to absorb capital flow shocks, provided they also possess deep financial markets and robust regulatory systems. However, these advantages come with increased exposure to volatility and require strong oversight to ensure continued competitiveness (Levy-Yeyati & Sturzenegger, 2005). In contrast, many emerging economies prefer fixed exchange rate regimes for their ability to anchor expectations and deliver price stability, but these systems can expose countries to the risk of sudden currency crises if macroeconomic fundamentals deteriorate, especially in the presence of high debt or weak fiscal positions (Kaminsky & Reinhart, 1999).

Table 2: Regression Results for Whole Sample

Dependent Variable: Financial Stability

Variables	**Coefficient**	**Std. Error**	**t-Statistic**	**p-value**
Intercept	0.312	0.072	4.33	0.000
EXR	0.108	0.028	3.86	0.000
GDPpc	0.000025	0.000007	3.57	0.001
INF	-0.01400	0.005	-2.8	0.006
POLSTAB	0.19400	0.041	4.73	0.000
R^2	0.69			

Table 3 shows that the coefficient for exchange rate is 0.105 and highly significant, implying that as the exchange rate increases (typically reflecting currency appreciation or stability), financial stability improves. This is consistent with the literature suggesting that a predictable and stable exchange rate environment reduces speculative behavior, encourages investment, and enhances confidence in financial systems. Reinhart and Rogoff (2004) emphasize that historically, countries with stable exchange rate regimes tend to experience fewer financial disruptions, especially when combined with sound macroeconomic management. Obstfeld, Shambaugh, and Taylor (2010) further argue that for developed economies, maintaining exchange rate stability is a cornerstone of the so-called macroeconomic trilemma, supporting both financial openness and policy autonomy. The coefficient for gross domestic product per capita is 0.0197, indicating that higher income levels are positively associated with financial stability. This finding aligns with empirical research linking economic development to the maturity and resilience of financial systems. As economies grow wealthier, they tend to develop more robust regulatory frameworks, enhance financial literacy, and expand access to diversified financial services. Beck, Demirgüç-Kunt, and Levine (2000) provide evidence that financial systems evolve in sophistication and depth with higher levels of income, while Levine (2005) discusses the reinforcing relationship between finance and economic growth. Inflation, represented by a negative coefficient of -0.012, demonstrates a statistically significant inverse relationship with financial stability. This supports the well-established notion that inflation undermines the value of financial assets, erodes purchasing power, and introduces volatility into financial markets. Studies such as Boyd, Levine, and Smith (2001) and Huybens and Smith (1999) confirm that high or volatile inflation environments weaken financial institutions by increasing uncertainty and discouraging long-term financial contracts and investments. Trade openness shows a positive coefficient of 0.002, suggesting that more open economies tend to enjoy greater financial stability, though the effect

size is modest. This relationship can be explained by the benefits of international trade in fostering economic diversification, enhancing access to capital, and encouraging competitive pressures that lead to financial innovation and better regulatory practices. Kose et al. (2006) and Rajan and Zingales (2003) argue that economies more integrated with global markets are often more disciplined in maintaining sound financial structures and implementing necessary reforms. The most influential variable in the model is political stability, with a coefficient of 0.2051. This underscores the critical importance of institutional quality and governance in ensuring a stable financial environment. Political stability supports regulatory enforcement, reduces risks of abrupt policy shifts, and fosters investor confidence. La Porta et al. (1998) highlight the role of legal and political institutions in the development of financial systems, while Kaufmann, Kraay, and Mastruzzi (2010) demonstrate that political stability directly correlates with better economic and financial outcomes through effective governance.

Table 3: Regression Results for Developed Economies

Dependent Variable: Financial Stability

Variables	Coefficients	Std. Error	t-Statistic	p-value
Intercept	0.3205	0.072	4.48	0.000
EXR	0.105	0.007	15.63	0.000
GDPpc	0.0197	0.0307	20.62	0.000
INF	-0.012	0.004	-3.04	0.003
OPEN	0.002	0.001	3.38	0.001
POLSTAB	0.2051	0.027	7.58	0.000
R^2	0.900			

The exchange rate (table 4) shows a coefficient of 0.0894 and is highly significant, indicating that a one-unit increase in the exchange rate is associated with a 0.0894 unit increase in financial stability. This reinforces the idea that exchange rate stability is a cornerstone of financial resilience in developing economies. These economies often lack deep financial markets or fully autonomous monetary institutions, and as such, adopting a fixed or intermediate exchange rate regime can anchor inflation expectations and enhance credibility. This interpretation aligns closely with the insights of Ghosh, Gulde, and Wolf (2003) and Klein and Shambaugh (2010), who emphasize that developing countries gain credibility and control through managed exchange rate systems, which help in reducing volatility and instilling monetary discipline.

The coefficient for gross domestic product per capita is 0.0000183, which is statistically significant at the 1% level. Although the magnitude is small, reflecting the use of actual income values rather than logarithmic transformation, it nonetheless confirms that higher income per capita is associated with greater financial stability. This is consistent with the economic development literature, which highlights how income growth contributes to institutional capacity, public trust in financial systems, and improved regulatory practices. The relationship is in line with the findings of Beck, Demirgüç-Kunt, and Levine (2000), who observed a robust link between financial development and rising income levels.

Unlike in developed economies, inflation does not appear statistically significant in this model, with a coefficient of -0.0047 and a p-value of 0.134. While the negative sign aligns with the theoretical expectation that inflation undermines financial stability, the lack of statistical significance suggests that inflationary pressures in developing economies may be more variable or mitigated by other institutional factors. It may also reflect the heterogeneity in policy responses or the influence of external stabilization mechanisms like IMF support or dollarization practices. Boyd, Levine, and Smith (2001) and Huybens and Smith (1999) argue that inflation can have destabilizing effects, but the strength of this relationship can vary based on how inflation is managed and perceived in specific contexts.

Trade openness is positively associated with financial stability, with a coefficient of 0.0021, significant at the 1% level. This indicates that increased engagement in international trade enhances financial stability by facilitating capital inflows, encouraging competitive markets, and integrating domestic financial institutions into global frameworks. For developing economies, openness can serve as both a signal and a mechanism of economic discipline, attracting foreign investment and encouraging the adoption of international best practices. These effects are documented by Kose et al. (2006), who suggest that financial openness and trade liberalization contribute positively to financial development when paired with sound domestic institutions.

Political stability remains an important determinant of financial stability in developing countries as well, with a coefficient of 0.1685. Though slightly smaller than in developed economies, this coefficient is still large and highly significant, confirming that governance quality and institutional continuity are essential for sustaining financial system

integrity. In fragile political environments, uncertainty can lead to capital flight, reduced investment, and weak enforcement of financial regulations. The literature by La Porta et al. (1998) and Kaufmann, Kraay, and Mastruzzi (2010) affirms that political institutions are foundational for the development and stability of financial sectors.

Table 4: Regression Results for Developing Economies

Dependent Variable: Financial Stability

Variables	Coefficients	Std. Error	t-Statistic	p-value
Intercept	0.2895	0.038	7.57	0.000
EXR	0.0894	0.007	13.38	0.000
GDPpc	0.0000183	0.0000011	16.72	0.000
INF	-0.0047	0.003	-1.51	0.134
OPEN	0.0021	0.001	3.59	0.001
POLSTAB	0.1685	0.032	5.29	0.000
R^2	0.853			

The broader narrative emerging from this analysis supports the hypothesis that the effectiveness of exchange rate regimes in promoting financial stability depends on the institutional maturity and developmental stage of an economy. As noted in your summary and supported by earlier studies such as those by Levy-Yeyati and Sturzenegger (2005), developing economies often benefit from fixed or intermediate regimes, which reduce uncertainty and enhance credibility. Meanwhile, floating regimes are more effective in developed economies with advanced financial institutions that can absorb external shocks. However, the ultimate success of any exchange rate regime is contingent on prudent fiscal management, the availability of foreign reserves, and the strength of capital control tools. This reinforces the conclusion that exchange rate regimes do not determine financial stability by themselves, but rather operate through a complex interaction of institutional, policy, and external factors.

Discussion

This research confirms and extends existing literature on exchange rate regimes and financial stability. Previous studies have shown that in countries with mature financial markets and credible monetary institutions, flexible exchange rate regimes help absorb external shocks, often through currency depreciation (Calvo & Reinhart, 2002; Husain et al., 2005). Consistent with this, our research found that the U.S., U.K., and Canada achieved higher financial stability due to floating exchange rates, supported by low inflation, balanced current accounts, and strong domestic institutions. The effectiveness of floating regimes is largely determined by institutional strength—independent central banks and developed financial markets allow flexible rates to buffer against capital flow shocks and commodity price changes. However, floating exchange rates play a smaller role in stabilizing developing economies. In countries with thin markets and fiscal vulnerabilities, fixed or intermediate regimes often yield better outcomes, as found by Ghosh et al. (2003) and Klein & Shambaugh (2010). Our analysis of countries like Nigeria, Pakistan, and Indonesia shows that fixed regimes can contain inflation and stabilize reserves, though sustainability remains a concern without capital controls or sound fiscal policy.

Institutional strength is a central factor: developed economies benefit from independent central banks and transparent monetary policy (Barro & Gordon, 1983), supporting effective floating regimes. By contrast, developing countries lacking institutional capacity often experience inflation and speculative attacks under floating systems. Fixed or intermediate regimes, serving as nominal anchors, help build confidence in countries with high inflation, aligning with Reinhart & Rogoff (2004). However, persistent budget deficits or weak financial controls can undermine credibility regardless of regime (Kaminsky & Reinhart, 1999). Thus, exchange rate policy must complement overall sound economic management. Floating regimes are also praised for supporting monetary policy flexibility and shock absorption, particularly in developed economies. During the 2008 financial crisis, countries with floating rates could cut interest rates and employ quantitative easing more freely (Calvo & Mishkin, 2003). In contrast, less developed markets often face higher inflation and volatility under flexible regimes, especially if regulatory and market foundations are weak.

Beyond macroeconomics, our study links exchange rate regimes to financial reporting quality. Developed countries with floating regimes tend to have more transparent, reliable financial reporting. In contrast, fixed regime countries, especially in the developing world, often lag in disclosure and transparency, which can undermine investor confidence (Grey, Kouhy & Lavers, 1995). The form of exchange rate management thus affects both financial stability and transparency. Sector-specific impacts also vary: financial services in developed countries benefit from floating regimes through market-driven risk management and financial innovation (Larrain & Velasco, 2001). However, in markets dominated by state-owned banks, floating rates may increase uncertainty and reduce lending. Trade-oriented sectors have different preferences—exporters favor floating

rates for currency flexibility, while importers value the stability of fixed regimes (Edwards & Savastano, 1999). As a result, policymakers must weigh sectoral interests, as no single regime fits all.

Regarding sustainability, fixed regimes can provide temporary stability but may face long-term viability challenges. Past crises in Latin America and Southeast Asia highlight the vulnerability of fixed regimes to speculative attacks if reserves or fiscal positions are weak (Obstfeld & Rogoff, 1995). Maintaining a fixed peg can require high interest rates, potentially slowing growth. Conversely, floating regimes sometimes prompt intervention to avoid large currency swings, risking policy inconsistency and increased volatility (Calvo & Reinhart, 2002). Clear, credible communication and policy consistency are thus essential for the success of any exchange rate regime.

Conclusions

Using a comprehensive dataset and mixed sampling techniques, this research examined how different exchange rate regimes affect financial stability in developed and developing countries. The findings show that exchange rates cannot be managed uniformly across all nations. Success depends on the development stage, institutional strength, and macroeconomic management. In advanced economies, floating regimes promote financial stability due to strong institutions, independent central banks, and deep financial markets, allowing for responsive monetary policy and rapid adaptation to external shocks. In contrast, developing countries often experience more volatile inflation, making fixed and intermediate regimes more effective, provided they have sufficient reserves and strong fiscal and regulatory frameworks. Institutional strength is critical: robust central banks, effective oversight, and transparent financial reporting can enhance the performance of any regime. For developing countries, institutional reforms should focus on strengthening monetary authorities and improving administrative controls before considering greater exchange rate flexibility. Given the complexity of modern finance, including digital currencies and algorithmic trading, exchange rate systems must now be more adaptable and tailored to national circumstances. Universal policy prescriptions are impractical; regimes must fit each country's unique needs to support financial stability and sustainable growth. Developed countries should ensure that monetary institutions are modernized and inflation frameworks are credible before fully adopting floating regimes, while maintaining adequate reserves. Fixed or intermediate regimes—guided by capital controls and oversight—can help stabilize economies in transition. Openness and improved financial reporting should accompany exchange rate policies to boost investor confidence and reduce information asymmetry. Sectoral considerations are essential: exporters may benefit from flexibility, while importers may prioritize stability. Effective coordination between trade, monetary, and fiscal policy is key to aligning exchange rate policies with broader economic objectives. International organizations should provide targeted guidance to help countries evaluate institutional readiness and enhance regime credibility, rather than offering one-size-fits-all solutions.

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