

Friedman Redux: External Adjustment and Exchange Rate Flexibility[†]

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Abstract

Do flexible exchange rates facilitate external adjustment as argued by Milton Friedman? Recent studies find surprisingly little robust evidence that they do. This paper argues that this is because they use aggregate exchange rate regime classifications, which often mask very heterogeneous bilateral relationships between countries. Constructing a novel dataset of bilateral exchange rate regimes for a sample of 181 countries over 1980–2011, we find a significant and empirically robust relationship between exchange rate flexibility and the speed of external adjustment. Our results are supported by several “natural experiments” of exogenous changes in bilateral exchange rate regimes.

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