Thus, a target-zone regime that lacks credibility is not likely to be effective in achieving its goals of policy independence and exchange-rate stability.

2.5. Empirical Evidence on Interest Parity, Exchange-Rate Variability and Speculative Attacks

The interest-parity relation has been tested extensively. Under rational expectations, the relation implies that the difference between the percentage change in the exchange rate and the relevant interest-rate differential is unpredictable (on the basis of currently available information) and, on average, equals zero. There is evidence of significant departures from this relation for certain periods and currencies. The foreign-exchange premium or errors in expectations could potentially explain these departures. However, determinants of the risk premium and causes of errors in expectations are not well understood. Thus, although the interest-parity relation does not hold exactly, not enough is known about the sources of errors in this relation for policy makers to shake loose the constraints that the relation places on their actions.

Since the breakdown of Bretton Woods system of adjustable pegs in 1973, a wide spectrum of exchange-rate regimes has emerged. Countries in the European Monetary System (EMS) have pegged exchange rates between currencies within the system but floating exchange rates with other currencies. Most of the industrial countries outside the EMS operate on flexible exchange rates with respect to all major currencies. There is much greater diversity of exchange-rate regimes among developing countries. Latin American countries, in particular, have experimented with a large variety of fixed, flexible and hybrid exchange-rate regimes.

The post-Bretton-Woods period has also seen the elimination or relaxation of capital controls by many countries and the emergence of a global capital market. These developments have heightened concerns about the constraints that international financial markets place on domestic macro-economic policy. There is now considerable evidence about the kind of macro-economic problems experienced under different exchange-rate regimes.

- A key finding is that regimes with flexible exchange rates exhibit large fluctuations in the exchange rate.