Seðlabanki Íslands

Spot the difference: Economic performance and currency regimes in the global financial crisis

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The views expressed are my own and do not have to reflect those of the Central Bank of Iceland or the Monetary Policy Committee of the Bank

Introduction

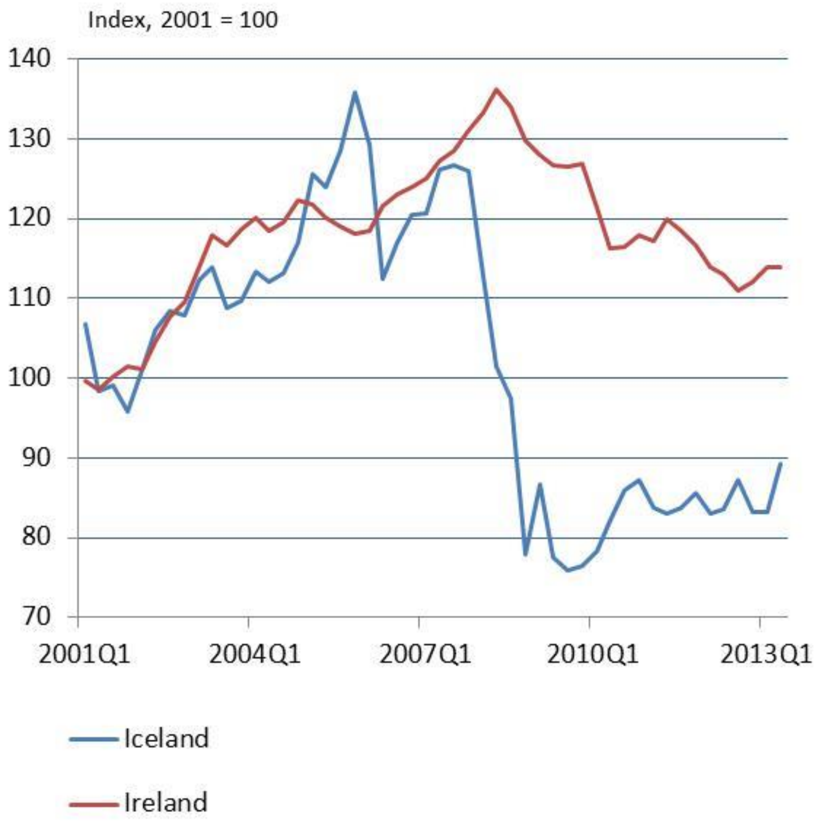
- An exchange rate is both a relative price that can absorb idiosyncratic shocks and an asset price that often seems unrelated to fundamentals
  - This fact makes the question whether fixed or flexible exchange rates are more suitable all the more difficult
- Both regimes can work and economic performance ultimately depends on sound economic policy rather than the exchange rate regime chosen
- To argue this point, I want to take a few examples from the recent global financial crisis

Economic performance in the crisis

Two countries – two currency regimes

- Iceland has followed a flexible exchange rate regime with an inflation target since 2001
- Ireland has been a member of a monetary union since 1999
- Despite this, the trends in the real exchange rates up to the global financial crisis are strikingly similar
- But the post-crisis development is radically different

Real exchange rate developments in two different exchange rate regimes



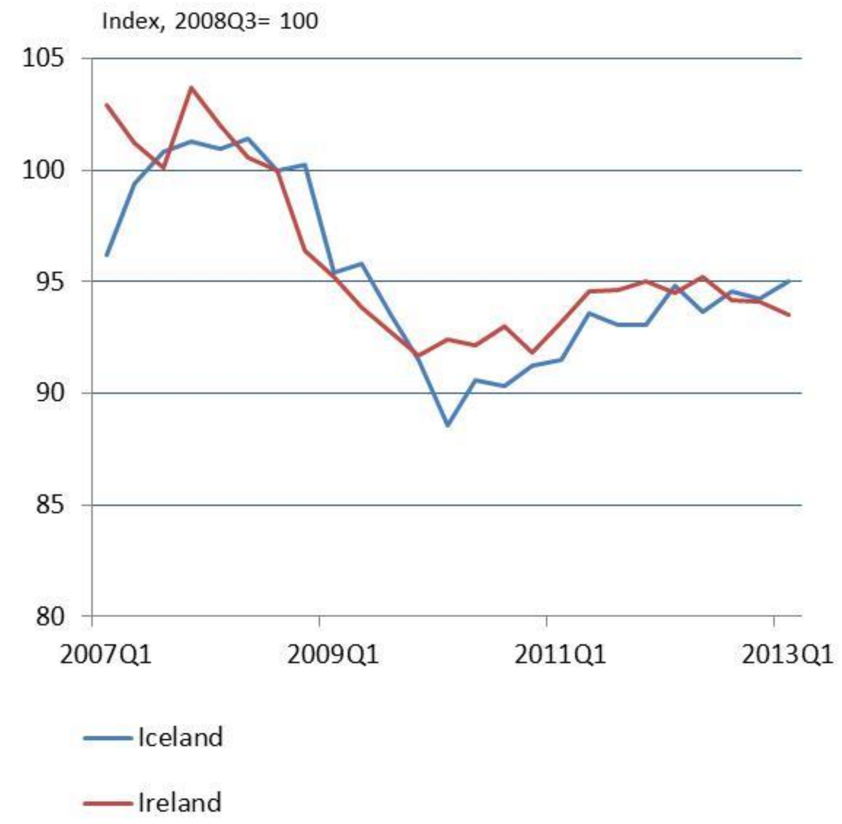
Source: Bank of International Settlements.

Economic performance in the crisis

Two countries – two currency regimes

- Did this dramatic difference in post-crisis real exchange rates lead to large differences in post-crisis economic performance?
- Not really
  - Both countries troughed at a similar time
  - The contraction in Iceland was larger but the recovery from the trough somewhat stronger

GDP developments in two different exchange rate regimes

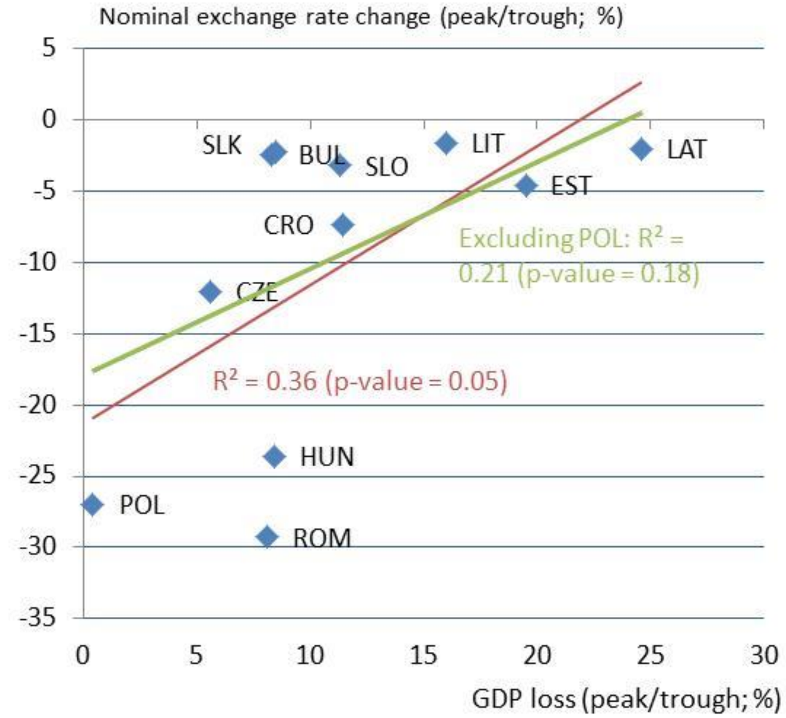


Source: Eurostat, Central Bank of Iceland.

Economic performance in the crisis
Did CEE's performance depend on the currency regime?

- At first sight it seems that CEE countries with more flexible exchange rates did better …
- … but at closer inspection, this observation seems largely driven by Poland's performance
- Excluding Poland, it becomes hard to argue that one regime outperformed the other
  - The peak-to-trough contraction is close to 10% in most of the countries irrespective of what exchange rate regime they use

GDP loss and nominal exchange rate flexibility in 11 CEE countries during financial crisis[1]



1. Change in nominal effective exchange rate real GDP between peak in 2005Q1-2008Q4 and trough following peak up to 2013Q1.

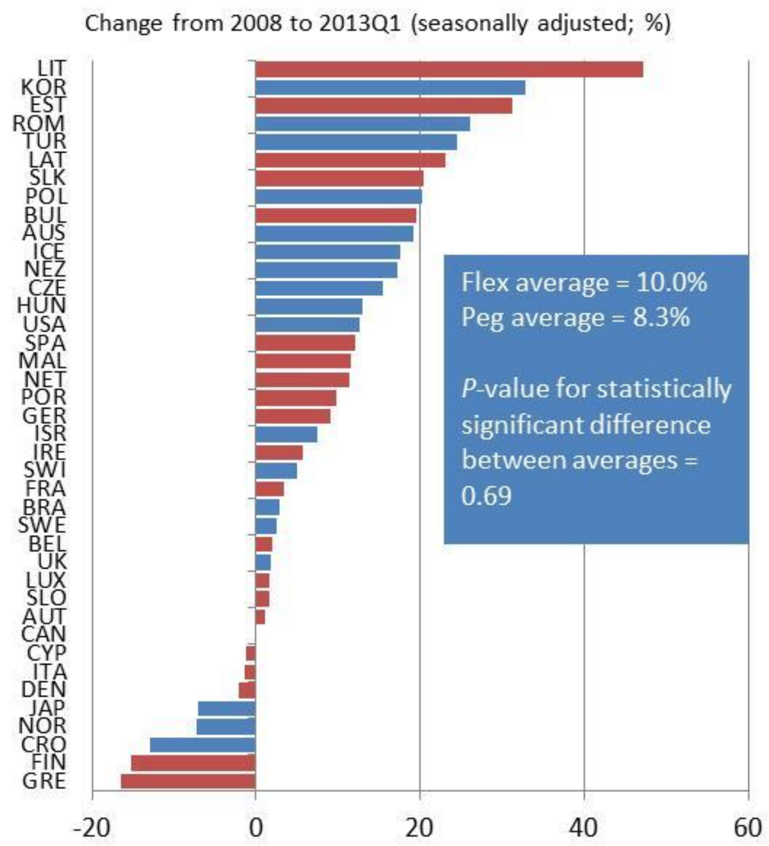
Sources: Bank of International Settlements, Eurostat.

Economic performance in the crisis

Did export recovery depend on the currency regime?

- What about the post-crisis export performance?
- Again, no clear pattern emerges
  - 2 of the top 3 and bottom 3 performers are pegs
  - Of the top 10 performers, 5 are pegs and 5 flexible
  - Of the bottom 10 performers, 6 are pegs and 4 flexible
- Difference between average performance not statistically significant
- Other factors probably more important than the actual currency regime in place
  - E.g. export structure and markets

Exports of goods and services in 40 countries after the global financial crisis[1]



1. Red bars indicate countries following a pegged exchange rate regime or within EMU. Blue bars indicate countries following a flexible exchange rate regime. *Sources:* Eurostat, OECD.

Economic performance in the crisis
Did the currency regime matter at all?

	GDP	Con-sumption	Unem-ployment
Peak/trough change (%)			
All	6.8	6.2	4.5
EMU	7.2	5.5	4.8
Non-EMU	6.5	6.5	4.3
Duration (quarters)			
All	5.3	5.7	6.5
EMU	6.3	6.7	7.2
Non-EMU	4.7*	5.2*	6.2

Country sample includes 46 medium- to high-income countries. * indicates that the difference between sub-group averages is statistically significant at the 10% level based on Satterthwaite Welch *t*-test.

Source: Central Bank of Iceland (2012). Iceland's currency and exchange rate policy options. *Special Publication*, no. 7, Chapter 17.

- A systematic comparison does not suggest any clear difference between economic performance depending on currency regimes
- A recent study by myself and a colleague suggests that factors related to pre-crisis imbalances were the decisive factor in determining how badly the real economy got hit by the global financial crisis

Conclusions

- Exchange rates and exchange rate regimes matter of course
- In the end, however, economic performance depends more on other factors
- The key to favourable economic outcomes is sound macroeconomic stabilisation policy
- Some may find that pegging to another currency or joining a monetary union to be a helpful disciplinary device to achieve that
- Others may find this step to be too constraining and the cost in terms of lost instrument too high
- Both can be right