Rethinking Exchange Rate Arrangements after the Crisis

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Rethinking Macroeconomics II – April 2013

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(part time visiting scholar at IMF, but opinions are purely my own)

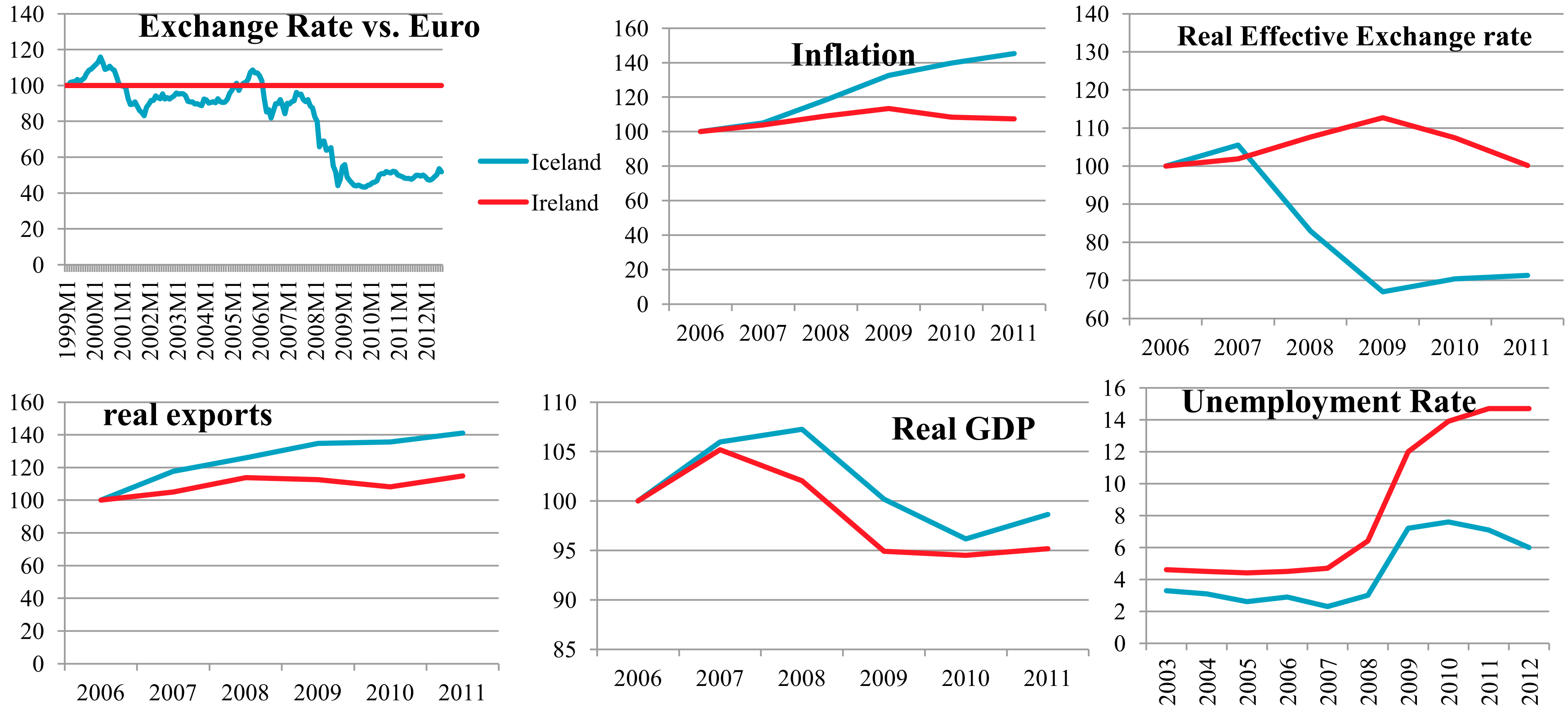
What did we learn?

- We have relearned things we should have known
- Key revelations regarding exchange rate regimes could have generally been described using advanced undergraduate international macro textbook. We were reminded:
  - Floating can serve as a shock absorber
  - ***External adjustment may be easier if you float***
  - Entering a currency union at the wrong price can really be painful
- Only real surprise:
  - Pegs that broke did not spiral wildly, most simply loosened their bands.
- On currency unions
  - Reminded us of what the institutional structure should be
  - Highlighted the costs of inadequate shock absorbers

Joke of early 2009

- What's the difference between Ireland and Iceland
- A: 1 letter and 6 months
- Reality: one has a floating exchange rate and one does not.
- Iceland likely in much worse shape coming in:
  - Banking sector bigger
  - CA deficit truly massive (>20% GDP in one year vs. 5% in Ireland.

Different experiences



- Not arguing Iceland was a shining star of policy management, or that Ireland should have abandoned euro. But when things get ugly, sometimes it's useful to be floating

More Broadly

- Countries like Israel, Poland, Sweden, UK (before austerity) seem to have benefited from their ability to depreciate immediately at the crisis.
- From 1990-2007, the median peggged and nonpegged country grew at roughly similar paces, but in the crisis, pegs grew about a percentage point slower.
- But:
  - Variance of shocks, other policies, etc. make that not conclusive
  - Some (Switzerland, Brazil at times) have seemed quite uncomfortable with their appreciation
- **Big question is what happens when adjustment is needed**

External Adjustment with fixed rates

- Difficulty with external adjustment and fixed E is well known.
  - Changing relative prices without changing E (especially downward) is difficult due to nominal rigidities
- 10 countries had CA/GDP < -10% and improved CA/GDP by more than 10 percentage points from 2008-11

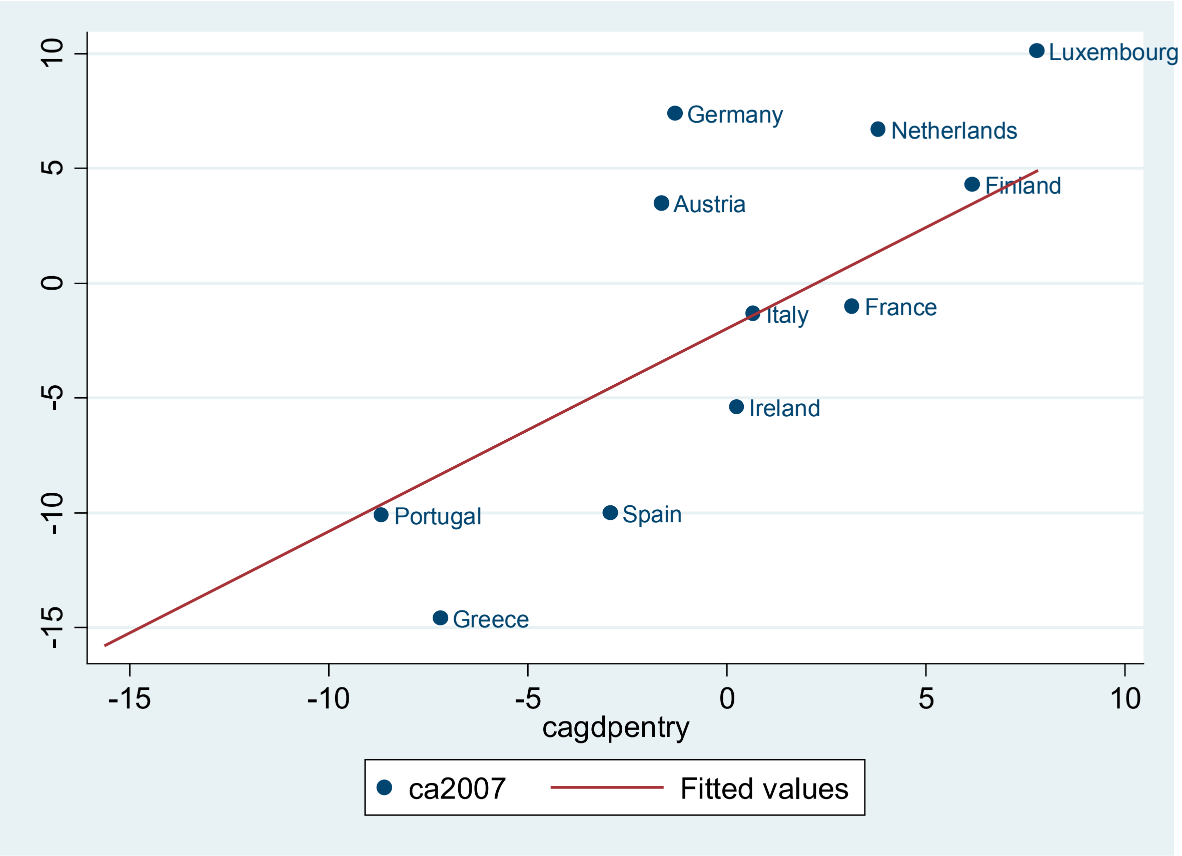
	number	# that grew	average ΔGDP	ΔE vs. base	ΔREER
pegs	6	0	-10%	0%	3% appr
non pegs	4	3	7%	15% dep	4% depr

- Small countries, small sample, but confirms general idea. It's possible, but difficult to adjust external account without changing E.

Entering a CU at the wrong price

- We've known entering a CU at the wrong price is painful since 1925
  - *Economic Consequences of Mr. Churchill*
- Convergence criteria focus:
  - Inflation
  - Debt & deficits
  - Stable E
- What about:
  - BOP ?
  - PPP ?
  - Fixing exchange rate permanently. Need to make sure relative prices are sensible to avoid the need for changing relative prices without changing E.

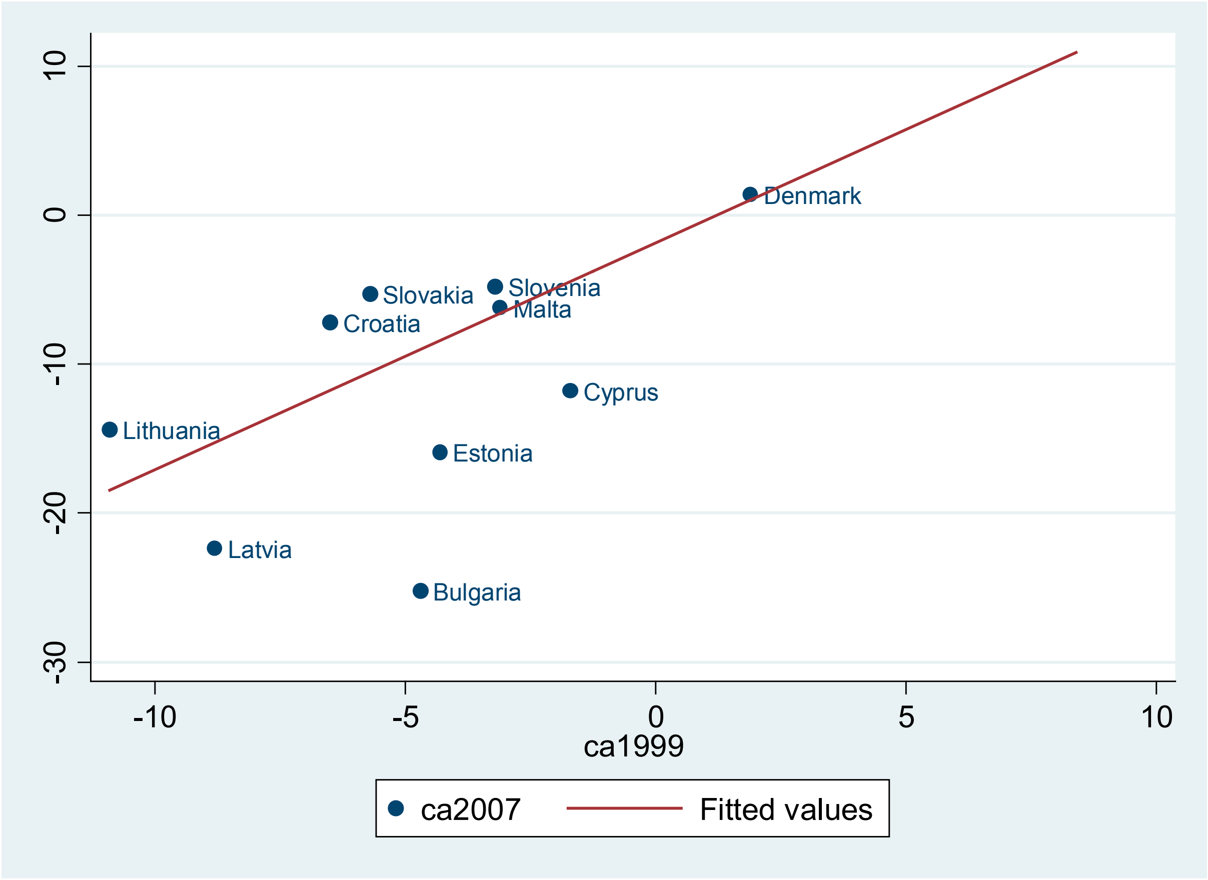
CA balances have been very sticky



Early entrants

- CA at entry explains 60% of variance of CA in 2007.
- Slope is roughly 1.

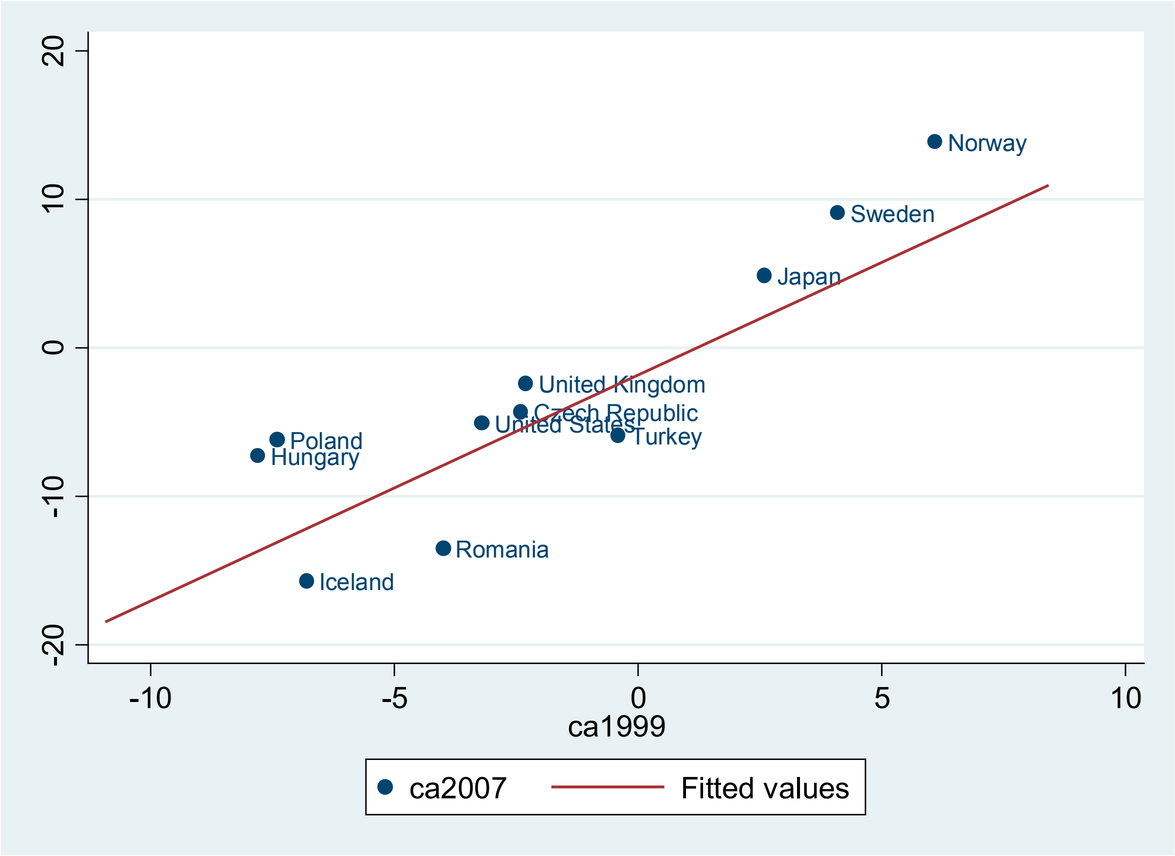
Roughly true for pegs



Recent entrants and pegs

- Again, slope roughly 1
- Explains roughly 30% of the variance

True for Floats!!!

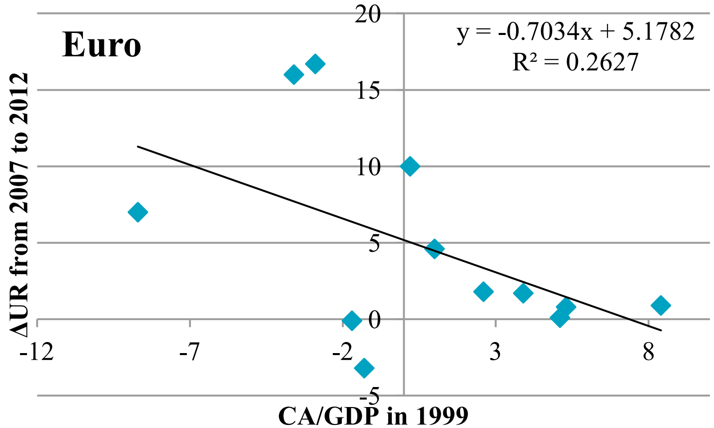


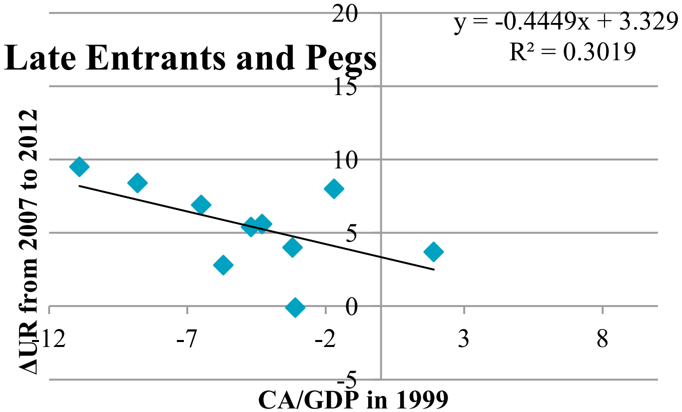
Floats from the eurostat sample

- Slope greater than 1
- Explains 70% of variation
- CA was very persistent prior to the crisis. Floating E does not predict "adjustment" towards balance.

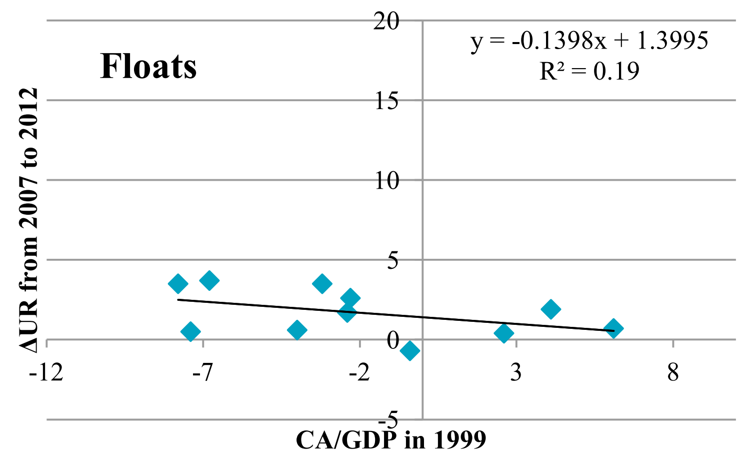
When adjustment happened, flexibility mattered

Figures: the change in the unemployment rate in the crisis (Y) against the CA in 1999 (X) across samples of countries

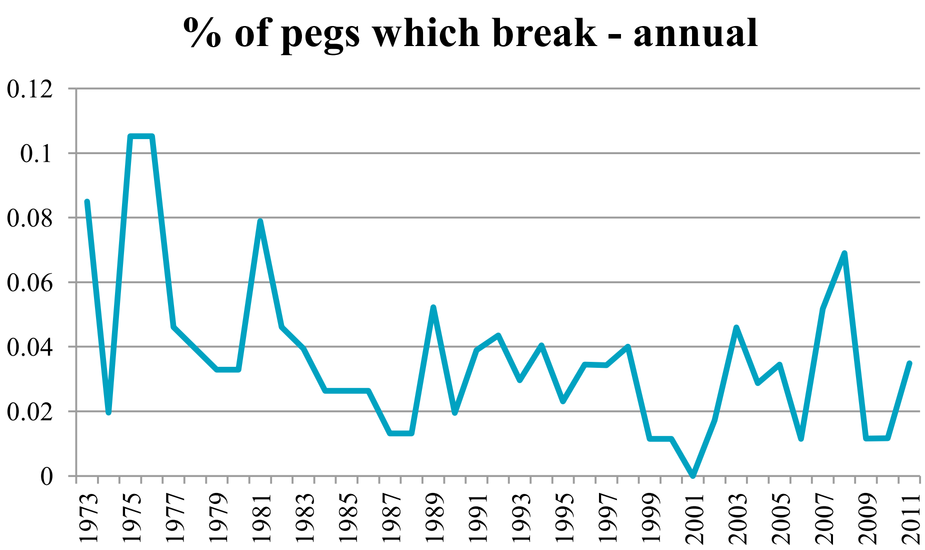


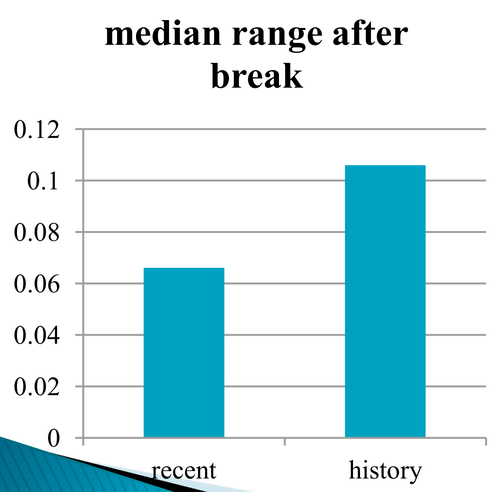


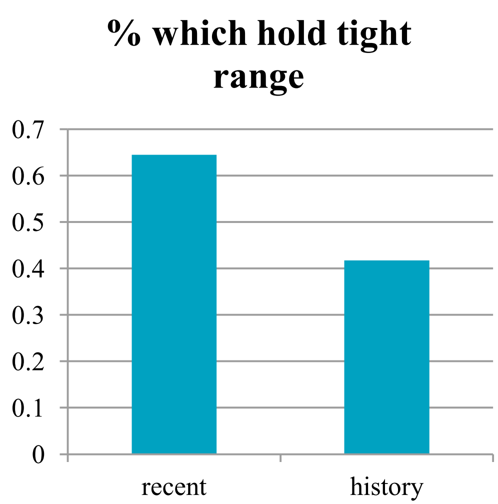
- CA in 1999 correlates with ΔUR in euro, somewhat in pegs, not much in floats.
  - Coefficient much bigger in euro
- Newest entrants also had CA defs
  - Cyprus: -16 in 2008
  - Slovenia: -5 in 2007
  - Slovakia: -3 in 2009
  - Estonia: + 2 in 2011



NEW: Pegs were fragile, but not combustible





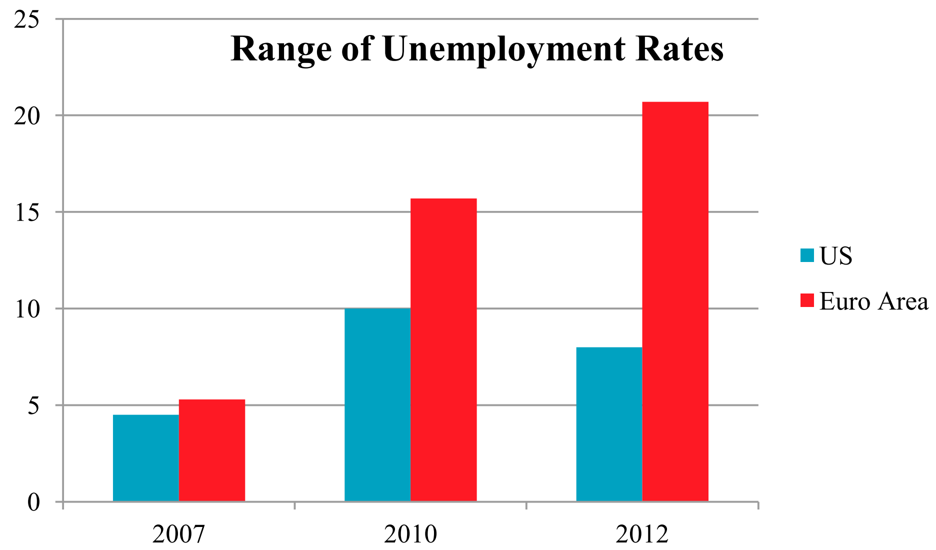


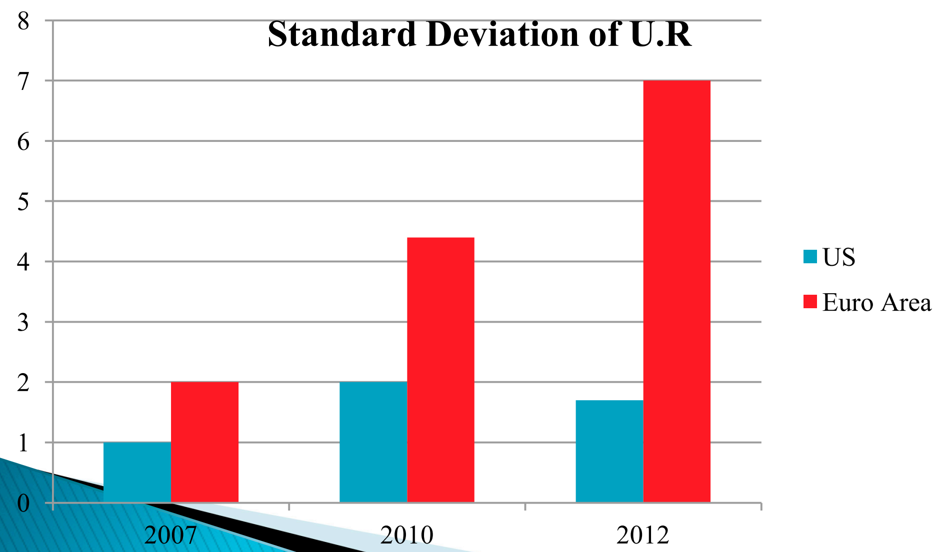
- This crisis saw it's fair share of peg "breaks"
- But they weren't massive crises, by and large, slight loosening of bands
- Preference for fixity is strong
  - ~50% are pegged at any point in time
- Despite the fact that crisis highlighted some of the concerns with pegging, many countries prefer pegging

CU institutions

- We've learned / been reminded of some of the costs of pegging – especially permanently.
- Need to look closely at the institutions that come with a currency union.
- The Euro in the crisis:
  - On average, non-euro advanced countries have grown faster during the crisis, and euro area unemployment rate is rising (relative to falling in most others).
  - But:
    - May simply reflect worse shocks
    - May simply reflect worse macroeconomic policy management
  - Euro floats against the world, so average performance is not a commentary on pegging or currency unions
- Big question is what happens when need for adjustment differs.

Shocks & absorbers





- Asymmetric shocks can hurt.
- Suggests a need for shock absorbers (which we've known since 1960 at least).
- Dispersion of unemployment rates in euro area and US both saw jumps, but it has gotten worse and worse in euro area.
- Lack of adequate shock absorbers
  - Labor mobility
  - Fiscal federalism

Implications

- In general, external adjustment is hard without flexible exchange rates
  - Need to avoid excessive borrowing with fixed E.
  - Need to cushion big shocks
- We've also learned more about fiscal policy and monetary policy at the ZLB (and that local fiscal policy in a CU can have big effects).
  - Need fiscal stabilizers at the CU level
  - Need to avoid excessive fiscal consolidation in recession
- We've relearned some macro finance linkages. Doom loops.
  - Need to keep bank weakness from being an asymmetric shock
  - Need CU wide:
    - Deposit insurance
    - Bank Supervision
    - LoLR
    - Resolution
- Most of all, euro area institutions are changing, but need to go far enough.
  - This crisis has revealed that we actually know a fair bit about the economics here. Can't ignore it when building institutions. Can't wish away these issues.

Thank You