Can Active Exchange Rate Policies Be Effective in Small States?

International Monetary Fund
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Road Map

- **Last conference: focus on competitiveness challenges and policy tools to address them**
- **Focus now: can an active exchange rate policy be effective in small states?**
- **What happened in practice after large devaluations in small states?**
  - **Output**
  - **External and fiscal positions**
  - **Inflation**
  - **Costs and benefits**
- **Key factors affecting outcomes**

The benefits of devaluation in small states same as in larger countries, but could be more muted

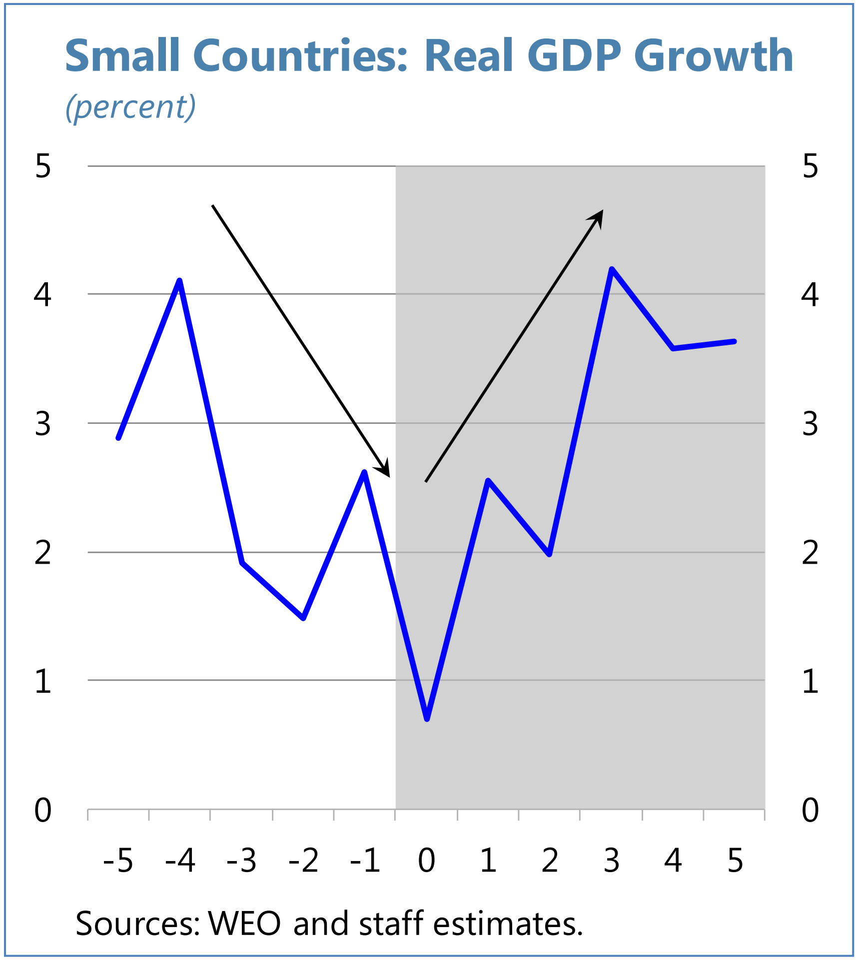
INDEED:

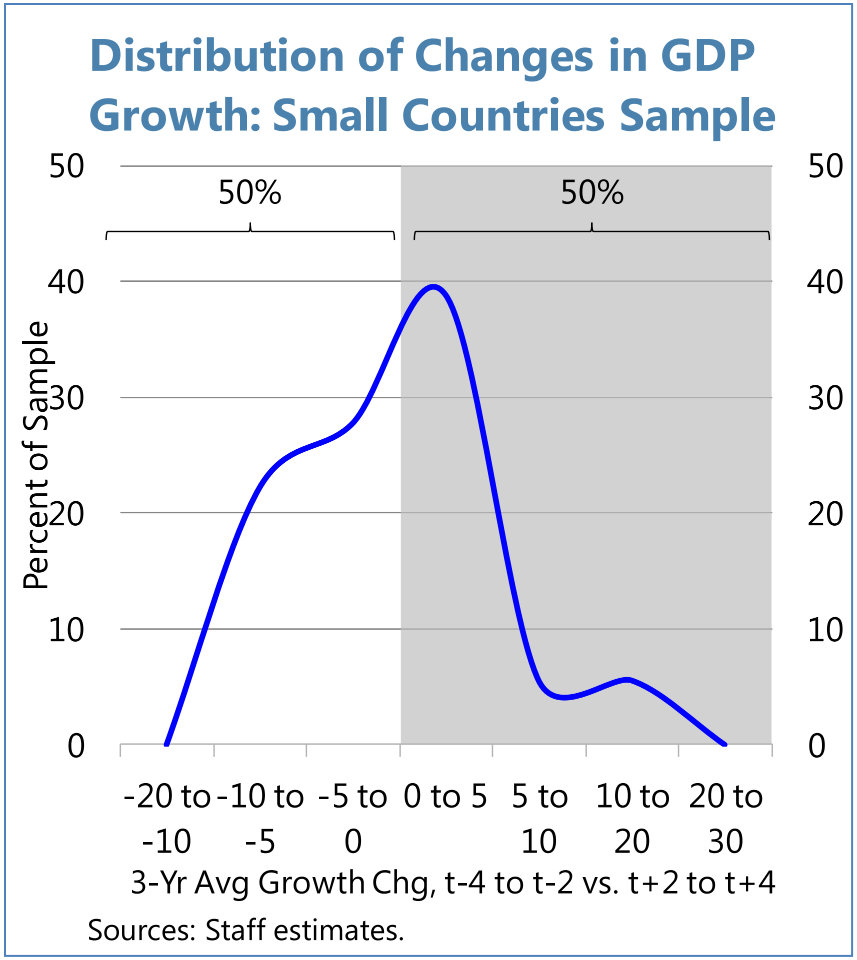
- **Exports less elastic**
- **Limited opportunities to switch expenditures**
- **Higher pass-through to inflation**
- **Consumption weak due to adverse income effects**

BUT…

- **Overall benefits same, especially if devaluation well managed**

Post-devaluation, growth picks up although slowdowns happen (same as in larger states)





Supporting policies can help boost growth

- **Public wage bill restraint improves likelihood of growth pickup**

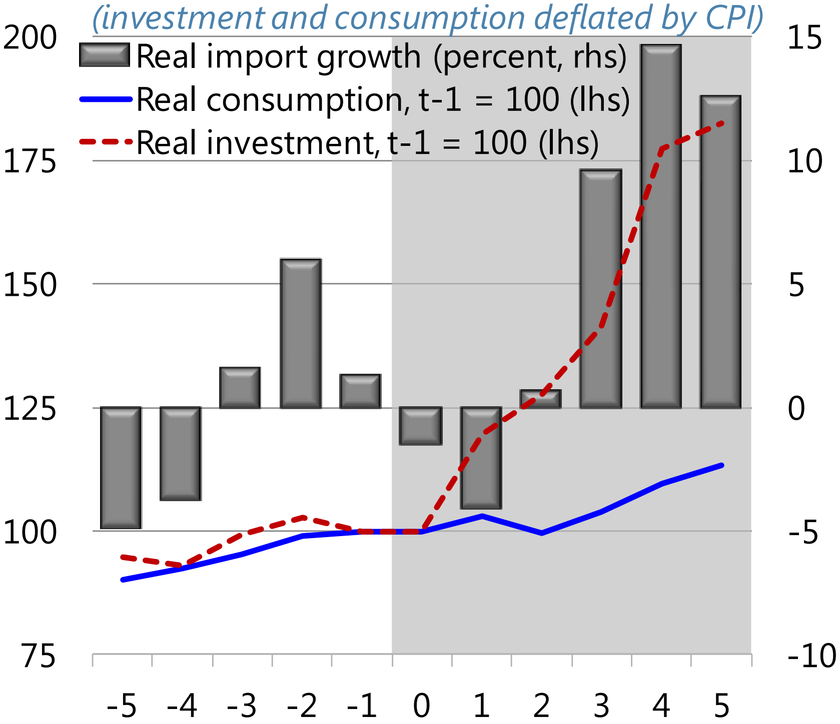
- **Structural reforms could remove bottlenecks to investment growth: key to a growth pickup**

Factors affecting the probability of a post-devaluation growth pick-up	
Factor	Effect
Being a small country	-
Increase in gov't wages/GDP	↓
Increase in investment/GDP	↑
Increase in other gov't exp/GDP	-
Note: Table reports signs of parameter estimates from a probit regression of a variable indicating a rise in average post-devaluation growth on these variables and other controls variables.	

Imports are compressed by weak consumption, but investment picks up…

Small Countries: Real Imports, Consumption, and Investment

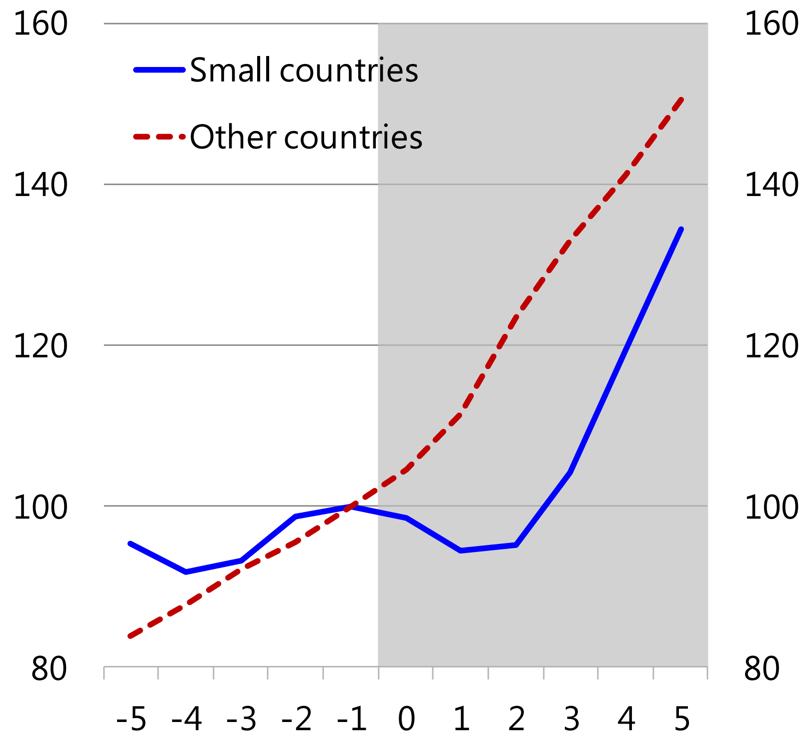
(investment and consumption deflated by CPI)



Sources: WEO and staff estimates.

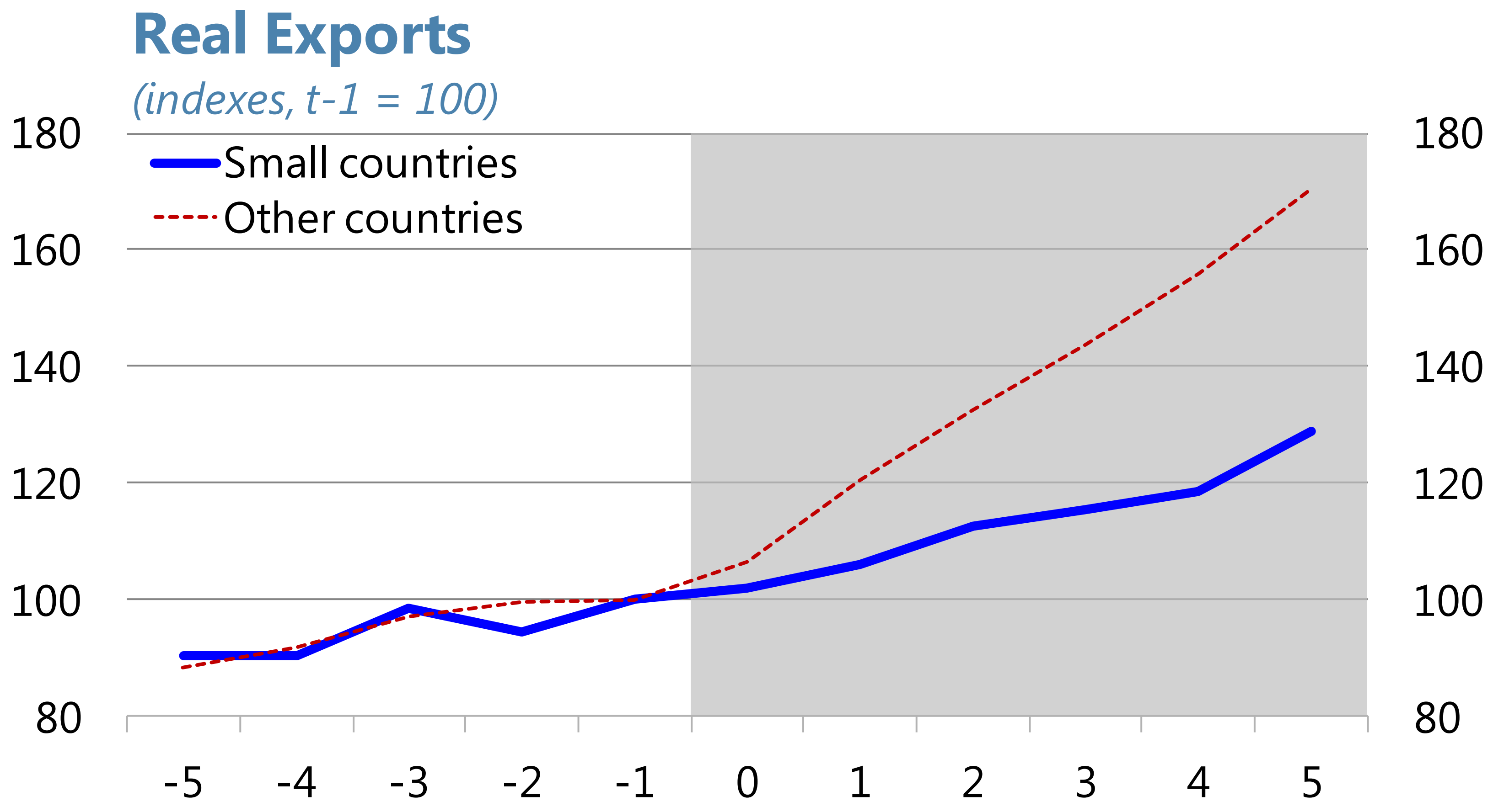
Real Imports

(indexes, t-1 = 100)



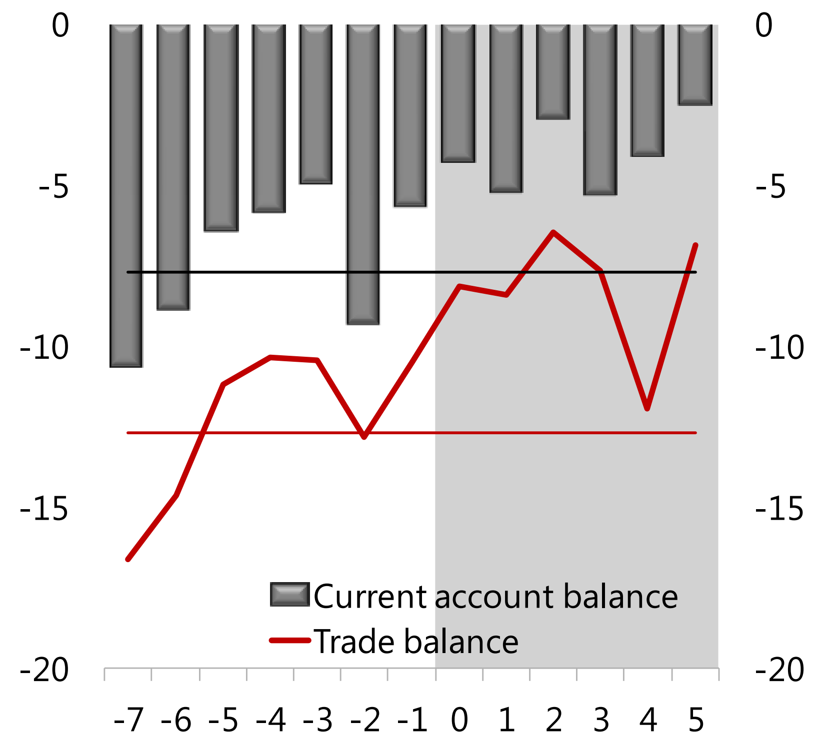
Sources: WEO and staff estimates.

Export growth doubles post-devaluation, albeit not as strong as in larger countries



Sources: WEO and staff estimates.

On average, both trade and current account balances improve



Sources: WEO and staff estimates.

Factors affecting the probability of improved current account balances

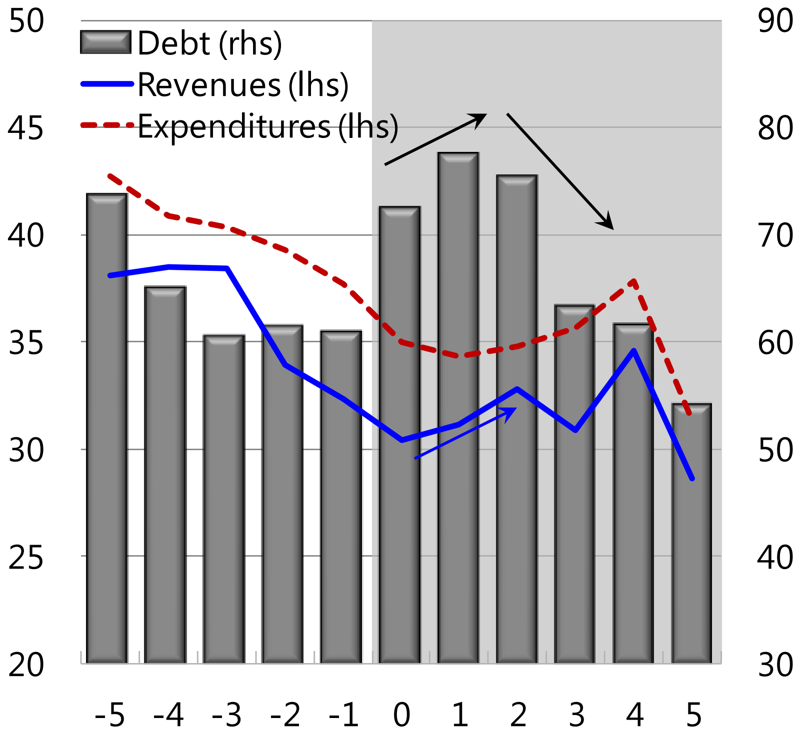
Factor	Effect
Being a small country	-
High debt burden	↓
Increase in Investment/GDP	↓
Increase in Consumption/GDP	↓

Note: Table reports signs of statistically significant parameter estimates from a probit regression of a variable indicating narrower current acct. balances after 5 years on the variables shown in the table.

The fiscal position improves gradually over the medium run, despite the initial jump in debt

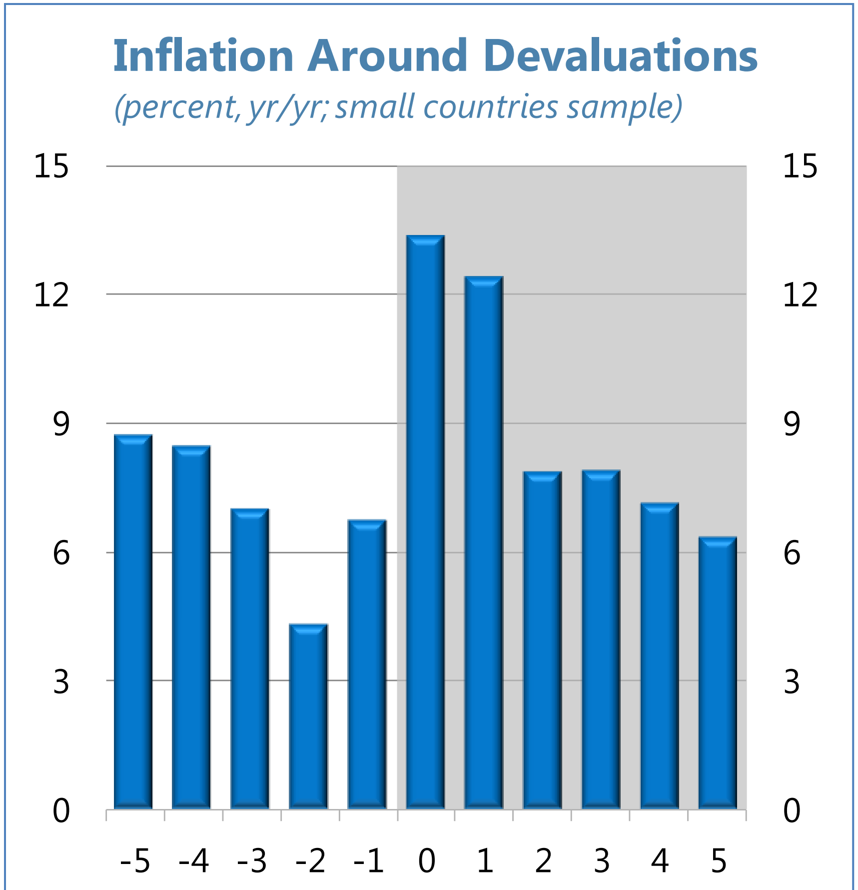
- **The devaluation causes a step increase in debt levels (valuation effect).**
- **Higher growth and narrowing deficits—helped by higher tax receipts from trade and often fiscal adjustments—lower the debt stock over time**

Small States: Fiscal Indicators
(percent of GDP)

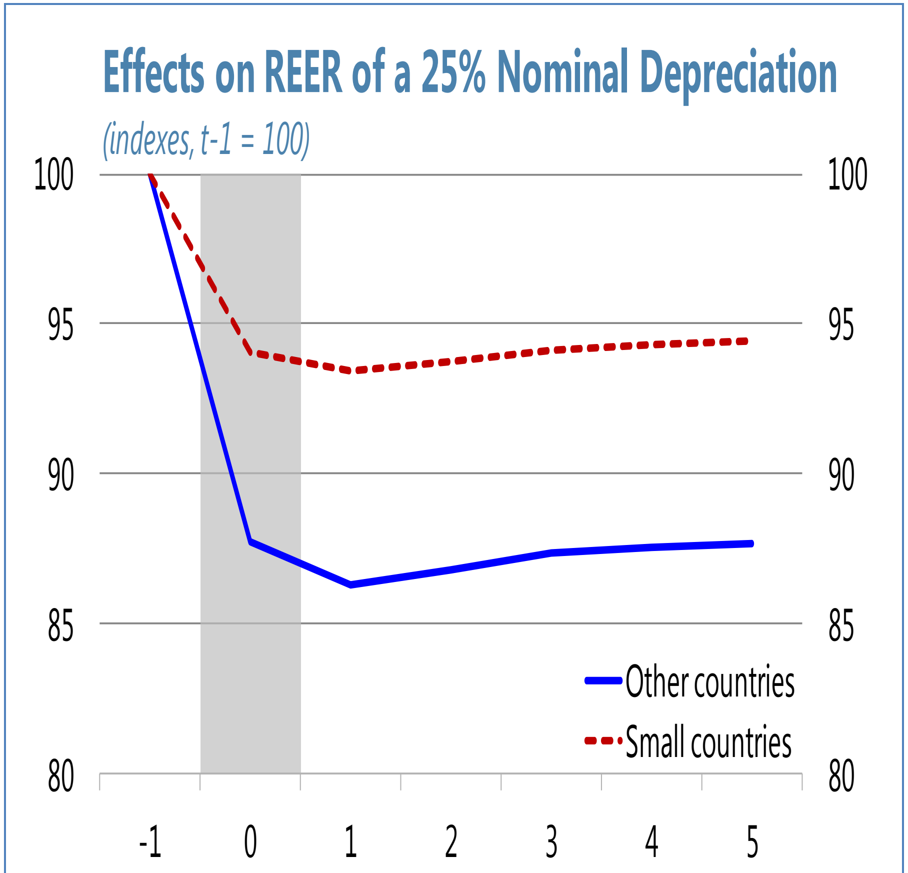


Sources: WEO and staff estimates.

The surge in inflation would dilute some competiveness gains, unless…



Sources: WEO and staff estimates.



Source: staff estimates.

… tight income and monetary policies are followed

Factors affecting the probability of a pickup in average inflation	
Factor	Effect
Being a small country	-
Increase in government wages/GDP	↑
Higher M2 money supply growth	↑
U.S. inflation	↓

Note: Table reports signs of parameter estimates from a probit regression of a variable indicating that inflation returns close to normal pre-devaluation levels by the third year after devaluation if no deflation occurred prior to the devaluation. If deflation occurred, inflation is under control in the third year if it is below the sample median.

Can devaluations succeed in small states? Yes, with supportive policies:

Devaluations work if accompanied by supportive policies

- Tight wage policies maintained after devaluation
- Structural reforms to allow a strong investment response
- Sustainable fiscal position to impart credibility to the devaluation
- Mitigating social costs through strengthened targeted social safety nets

Thank you