



The exchange rate — A shock-absorber or source of shocks? A study of four open economies

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Abstract

The paper provides SVAR estimates for the UK, Canada, Sweden and Denmark, making explicit a monetary policy reaction function and taking account of exchange rate targeting practices. It examines the role of the exchange rate as shock-absorber as opposed to a source of its own, and destabilizing, shocks. We find that in all countries but the UK, real shocks are predominantly symmetric relative to the neighbor, implying little need for the exchange rate to act as shock-absorber. The shocks arising in the exchange market appear to have played a more important role in Denmark than in the other countries.

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JEL classification: C32; E42; F31; F33

Keywords: Exchange rates; Structural vector autoregression; UK; Canada; Denmark; Sweden; EMU

1. Introduction

Traditional optimum currency area (OCA) analysis gives a special role to the exchange rate as a potential shock-absorber and stabilization mechanism; in effect, the “OCA null” is that exchange rates behave in this way. On the other hand, foreign exchange markets can actually

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contribute towards destabilization of the economy, as for example in times of exchange rate crisis. The role that is effectively played by the exchange rate is thus a critical issue.

For example, commenting on the position of the UK vis-à-vis EMU, [Buiter \(2000\)](#) has suggested that a principal benefit of EMU membership for the UK might well be to escape from the destabilizing effects of the sterling foreign exchange market: “Under a high degree of international financial integration, market-determined exchange rates are primarily a source of shocks and instability” ([Buiter, 2000](#), p. 213).

An article IV consultation document of the [International Monetary Fund \(1999\)](#) has also drawn attention to the fact that output fluctuations in the UK have in recent decades been relatively large; and that important roles for the interest rate and the exchange rate in generating those fluctuations can be identified. More recently [Kontolemis and Samiei \(2000\)](#) expanded on these points in an IMF working paper.

This paper proceeds to examine the issue raised by Buiter and the IMF empirically, using an SVAR approach. In order to provide perspective, however, the scope of the analysis is deliberately not restricted to the UK. Rather, we have chosen to examine the position of four countries which, like the UK, have large neighbors with whom they trade a great deal, and with whom monetary union (or a quasi-union arrangement) is an important policy option. The four economies concerned are those of the UK, Canada, Sweden and Denmark. The UK, Sweden and Denmark all face the important option of participating in EMU. For Canada, whilst no formal option exists of joining the monetary union of the US, “quasi-union” options exist; for example, Canada could adopt a Currency Board arrangement or allow her economy to become (US-)dollarized. There has been a flurry of recent discussion of this type of option (see, e.g., [Buiter, 1999](#); [Courchene and Harris, 1999](#); [Laidler and Poschmann, 1998](#)). As illustrated below ([Table 1](#)), of these four countries the UK is the largest in relation to its ‘neighbor’ (whether this is taken to be Germany or the euro area). Canada and Sweden are of similar size relative to their neighbor (when Sweden’s neighbor is taken to be Germany), and Denmark is the smallest. When the relative size of Denmark and Sweden is measured against the euro area, both countries are considerably smaller than Canada.

Using an SVAR approach to examine the topic in question seems the most obvious way to proceed. The methodology directly concerns itself with the stochastic behavior of economies, which is the central issue here. Moreover, as detailed below, there are some antecedent studies with which our results can be compared. There is also a small but growing literature on SVAR estimation of open economies which provides some useful pointers for the current study.

We find that in all countries but the UK, real shocks are predominantly symmetric relative to the neighbor, such that there is little need for the exchange rate to act as shock-absorber. The

Table 1
Country comparison: size and openness

	Size relative to neighbor ^a	Export share in GDP	Import share in GDP	Share of exports to neighbor ^a	Share of imports from neighbor ^a
Canada	0.09	40.7	39.0	0.83	0.67
Denmark	0.07/0.02	36.0	32.0	0.22/0.44	0.22/0.51
Sweden	0.10/0.03	43.8	36.8	0.11/0.38	0.19/0.49
UK	0.66/0.20	28.7	29.2	0.11/0.46	0.12/0.44

Sources: OECD Main Economic Indicators, IMF Direction of Trade Statistics, own calculations.

^a Neighbor is US for Canada, Germany/euro area for the other countries. Relative size is measured on the basis of PPP-adjusted GDP. All data refer to 1997.

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