



Real effective exchange rate volatility and growth: A framework to measure advantages of flexibility vs. costs of volatility [☆]

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Abstract

By devising a real effective exchange rate (REER) index where bilateral exchange rates are weighted for relative trade shares, we find that the REER volatility (differently from the bilateral exchange rate volatility with the dollar) has significant impact on growth of per capita income after controlling for other variables traditionally considered in conditional convergence estimates. We also find that this (cost of volatility) effect can be reconciled with the

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concurring negative and significant effect on growth of the adoption of a fixed exchange rate regime (advantage of flexibility effect), where the latter may be also interpreted as the cost of choosing pegged regimes without harmonization of rules and macroeconomic policies with main trading partners. The adoption of an REER volatility measure, instead of a bilateral exchange rate with the dollar, has the advantage of making it possible a joint test for these two effects. This is because, while fixed exchange rate regimes are strongly negatively correlated, and almost collinear, with bilateral exchange rate volatility with the dollar, the correlation is much weaker when considering our REER volatility measure.

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1. Introduction

Two apparently opposite views in the literature exist when dealing with the effects of exchange rate regimes and volatility on growth.

The first, that we define *costs of volatility* argument (CVA), establishes that exchange rate volatility may be harmful for growth and thus provides indirect support to the creation of monetary unions (also MUs) which eliminate part of this volatility (Buiter et al., 1998). According to this perspective, the elimination of exchange rate volatility among Union members (Buiter et al., 1998; Devereux et al., 2003) is generally considered a beneficial effect, given the perception that “unpredictable volatility can inflict damage” . . . [and that] . . . “Although the associated costs have not been quantified rigorously, many economists believe that exchange rate uncertainty reduces international trade, discourages investment and compounds the problems people face in insuring their human capital in incomplete asset markets.” (Obstfeld and Rogoff, 1995).

On the same line, De Grauwe and Schnabl (2004) emphasise that, while Mundell (1961) theory of OCAs (which they term as Mundell I, following a classification proposed by McKinnon (2003)) suggests the well-known caveats to be considered before opting for a MU (minimum level of trade integration, limited occurrence of asymmetric shocks, sufficient mobility of workers), Mundell (1973a,b) (or Mundell II) provide quite different prescriptions. When exchange rate movements are an independent source of volatility and are also driven by speculative dynamics,¹ anticipated entry into MUs may help small open economies to avoid negative macroeconomic effects of exchange rate volatility. De Grauwe and Schnabl (2004) empirical findings support this hypothesis finding a positive association between exchange rate stability

¹ The second generation of currency crisis models is very akin to this way of thinking since it shows how crises do not need to be triggered by misalignment of fundamentals but also from self-fulfilling agents expectations (Obstfeld, 1986, 1994).

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