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Exchange rate volatility and growth in small open economies at the EMU periphery

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Abstract

Since the introduction of the euro in January 1999, exchange rate stability in the periphery of the euro area is growing. The paper investigates the impact of exchange rate stability on growth for a sample of 41 mostly small open economies at the EMU periphery. It identifies international trade, international capital flows and macroeconomic stability as important transmission channels from exchange rate stability to more growth. Panel estimations reveal a robust negative relationship between exchange rate volatility and growth for countries in the economic catch-up process with open capital accounts.
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1. Introduction

The international role of the euro is growing. An increasing number of private and public agents in the countries in the periphery of the European Monetary Union (EMU) are using the euro as an invoicing, vehicle, banking, pegging, intervention and reserve currency (ECB, 2005; Kamps, 2006). For the official exchange rate policies the role of the euro has not only increased in countries associated with the European integration process, but also beyond the EU27,[1] for instance in Russia (Schnabl, 2006a) and East Asia (Schnabl, 2006b; Kawai, 2006).

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The growing role of the euro as an anchor currency for the countries in the periphery of the EMU[2] raises the question about the pros-and-cons of exchange rate stabilization against the euro. With the 1997/1998 Asian crisis, the downsides of (softly) fixed exchange rates which are suspected to encourage speculative capital inflows, moral hazard, and overinvestment have become visible (Fischer, 2001). Proponents of flexible exchange rates have also emphasized the need for macroeconomic flexibility in the face of real asymmetric shocks. In contrast, proponents of fixed exchange rates have stressed the (microeconomic) benefits of low transaction costs for international trade (Frankel and Rose, 2002) as well as the impact of trade integration on the probability of asymmetric economic developments (Frankel and Rose, 1998).

While asymmetric shocks and trade integration have remained the most important criteria in the academic discussion about the pros-and-cons of (irrevocably) fixed exchange rates, we will argue that capital markets and macroeconomic stability also matter. For countries in the economic catch-up process where capital markets remain underdeveloped and macroeconomic instability tends to be high, fixed exchange rates are an important anchor for macroeconomic policies and private expectations.

Previous research on the impact of exchange stability on growth has tended to find weak evidence in favour of a positive impact of exchange rate stability on growth. For large country samples such as that by Ghosh et al. (2003), there is weak evidence that exchange rate stability affects growth in a positive or negative way. The panel estimations for more than 180 countries by Edwards and Levy-Yeyati (2003) find evidence that countries with more flexible exchange rates grow faster. Eichengreen and Leblang (2003) reveal a strong negative relationship between exchange rate stability and growth for 12 countries over 120 years. They conclude that the results of such estimations strongly depend on the time period and the sample.

While many previous studies have chosen very large samples to increase the robustness of the estimation process, this paper approaches the question from a different angle. It tests the impact of the exchange rate stability on growth for the EMU periphery, i.e. a smaller region where an increasing number of emerging market economies in the economic catch-up process have dismantled capital controls. As capital controls can be regarded as an important impediment to growth as they disconnect domestic capital markets from the very liquid global capital markets we can test for the impact of exchange rate stability on growth under the condition of free capital movements.

Building upon De Grauwe and Schnabl (2005a), we perform GLS panel estimations for 41 countries in the EMU periphery. The results provide evidence in favour of a robust negative relationship between exchange rate volatility and growth.

2. Empirical and theoretical evidence

At the borders of the euro area exchange rate stability is growing. An increasing number of countries peg their exchange rates (more) tightly to the euro. Compared to the mid-1990s, exchange volatility of the countries bordering the euro area has decreased considerably. The role of the euro as an anchor currency is growing steadily at the cost of the US dollar. While in central, eastern, and south-eastern Europe the growing exchange rate stability against the euro can be

[2] We define the EMU periphery as the countries of the regions bordering the EMU. These countries include all European non-EMU countries which are not microstates. In addition we add the countries bordering the Mediterranean Sea and the members of the Commonwealth of Independent States.

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