Available online at www.sciencedirect.com
SciVerse ScienceDirect
Procedia Economics and Finance 3 (2012) 18 – 23
Procedia Economics and Finance
www.elsevier.com/locate/procedia

Emerging Markets Queries in Finance and Business

Exchange Rate Regimes and Economic Growth in Central and Eastern European Countries

Iulian Ihnatov[a,]*, Bogdan Căpraru[a]

[a]Alexandru Ioan Cuza University of Iași, 700 505, Romania

Abstract

One of the questions that have not received a clear answer by academics yet is if the exchange rate regime choice could influence the economic growth. The success of the stabilization programs based on exchange rates, the pegged exchange rate arrangements brake up in some emerging countries, the current difficulties in the Euro zone show why this topic is still controversial and important. We used OLS and GMM methods to estimate a growth model with dummy variables that isolate the effect of exchange rate regimes on economic growth. The research has been employed on 16 Central and Eastern European countries, where the exchange rate arrangement choice is a key point in the years before Euro adoption. We got statistically significant coefficients for the regime dummy variables, independently of the estimation method. Our results suggest superior effect on economic growth of the floating and intermediate regimes comparing to the fixed arrangements. Although the exchange rate stability is commonly viewed as stimulation for economic growth, it seems that it doesn't support growth if it was obtained by massive interventions of the monetary authorities to support the exchange rate level. Our surprising result does not explain why a major part of the selected countries adopted hard pegs, although the flexible regimes apparently stimulate growth. It is possible that currency boards are not suitable for long periods of time, but just for a quick economic stabilization.

Selection and peer review under responsibility of Emerging Markets Queries in Finance and Business local organization.

Keywords: exchange rate regimes; economic growth; Central and Eastern Europe

1. Introduction

The implications of currency regimes choice on economic growth have been and still are the topic for debate both in the academic world and for the policy makers. The problem is extremely actual taking into account that

* Corresponding author. Tel.: +40-232-201569; fax: +40-232-217000.
E-mail address: iulian.ihnatov@uaic.ro.

2212-6716 © 2012 The Authors. Published by Elsevier Ltd.
Selection and peer review under responsibility of Emerging Markets Queries in Finance and Business local organization.
doi:10.1016/S2212-5671(12)00115-3

after more than three decades since the fall of the Bretton Woods fixed exchange rates there is a variety of exchange rate policies at international level. The research on this topic is justified through the relatively recent successes of the stabilization programs based on exchange rates as well as the fall of fixed exchange rate regimes in some emergent countries, the introduction of Euro and the difficulties faced by the Economic and Monetary Union after over a decade of existence.

In the 1990 report, the European Commission conducted an analysis which drew the conclusion that currency risk elimination stimulates the economic growth. The analysis lies on a neo-classical growth model inspired by Baldwin, 1989. The benefits of the single currency adoption can be amplified by the high degree of openness of an economy. For example, the elimination of transaction costs brings higher gains to the countries where the weight of commercial relations with the EMU countries is higher. The probability of decision errors due to the existence of commercial relations with many countries with different currencies also diminishes. The elimination of these risks brings major benefits per capita to the small and open economies in comparison with large and closed economies.

In this study we aim at evaluating the effect of exchange rate regimes on economic growth for 16 Central and East European countries for the period 1999-2010, using the IMF *de jure* classification of currency regimes.

2. Literature review

The topic of consequences of exchange rate regimes choice on economic growth has been approached by several researchers whose main empirical results will be mentioned in what follows.

The first efforts of empirical study of the relationship between the currency regimes and the economic growth on a long-term happened in the 1980s. An already considered classical study (Baxter and Stockman, 1989) showed that the volatility of the exchange rates was different in the case of fixed regimes in comparison with the floating ones; still it did not identify differences between the two groups of countries as regards the GDP growth rate.

Mundell, 1995 concluded that the highest increases in the real income per capita were registered during the functioning of fixed currency regimes. Moreno, 2001 in his study on a panel of developing countries, supported the idea of a higher economic growth (by 3%) through the adoption of fixed exchange rate systems.

Gosh et al., 2002 using their own exchange rate regime classification, discovered a slight superiority of fixed exchange rate regimes to stimulate economic growth, but the results of the study are not robust. The authors reached the conclusion that there is not a strong correlation between the adopted exchange rate regime and the economic growth.

Levy-Yeyati and Sturzenegger, 2005, who used their own *de facto* classification, discovered that for the non-industrialized countries the fixed regimes seemed to be connected with reduced and very volatile rates of economic growth.

Hussain, Mody and Rogoff, 2005 used the Reinhart-Rogoff “natural” classification and discovered that the flexible regimes have a positive influence on economic growth in the developed countries, while in the groups of emergent and developing countries they did not identify any influence. Moreover, in the separate situations, characterised by hyperinflation, there is a more reduced economic growth. Bleaney and Francisco, 2007 criticized these results, identifying much bigger differences in favour of fixed exchange rates. The cause might be the drawbacks of the “natural” classification system, which offered different results from other classifications.

Aghion et al., 2006 proved that the volatility of the real exchange rate may have a major impact on the productivity growth rate on a long run, but this effect depends on the financial sector development in the sample countries. Thus, in the low financially developed countries the flexibility of exchange rate generally led to the drop of economic growth rate, while in the high financially developed countries there is not a significant effect.