



Crisis and recovery: Role of the exchange rate regime in emerging market economies

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ABSTRACT

Following the recent global financial crisis, questions about the mechanisms that can help countries cope with large shocks have resurfaced. This paper examines the role of the exchange rate regime in explaining how emerging market economies fared in the recent global financial crisis, particularly in terms of output losses and output rebound. After controlling for regime switches during the crisis, using alternative definitions for pegs, and taking account of other likely determinants, we find that the growth performance for pegs was not different from that of floats during the crisis. The picture is different for the recovery period 2010–2011, as pegs appear to be faring worse, with growth recovering more slowly than floats. These results suggest an asymmetric effect of the regime during and recovering from the crisis. We also find that proxies of the trade and financial channels are important determinants of growth performance during the crisis, while only the trade channel appears important for the recovery thus far.

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1. Introduction

Emerging market economies (EMEs) are increasingly important drivers of global economic growth, as witnessed by the substantial increases in their share of world output during the last four decades. Although EMEs were not at the epicenter of the recent global financial crisis, the crisis spread to them quickly. At the beginning of the crisis, debate focused on whether they would follow the advanced economies into a recession or whether decoupling would help lessen the impact of the recession. Pessimists argued that decoupling was not possible in an era of globalization as business cycles have become more synchronized through trade and finance. Optimists pointed to increases in trade among emerging and developing economies, as well as increases in productivity growth and domestic incomes as signs that emerging and developing markets were “learning to spread their wings”.

As the crisis intensified, signs surfaced that cast a shadow over the ability of EMEs to insulate themselves from shocks originating in advanced economies. Between the third quarter of 2008 and the first quarter of 2009—the most intense period of the crisis—real output growth in EMEs fell by more than 4% on average, as they faced a freezing of financial markets, a collapse in trade, and pronounced financial volatility magnified by deleveraging by banks worldwide. Once the worst of the crisis began to wear off and growth rates began to bounce back, it appeared that some EMEs may have actually weathered the global recession better than advanced economies.

The growth experience of the last three years holds important lessons for EMEs. One such lesson concerns the choice of exchange rate regime—an obvious question being whether the exchange rate regime can help explain how emerging market economies fared in this crisis, particularly in terms of output losses and growth resilience. Theory suggests that exchange

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rate flexibility, by easing adjustment, should be associated with smaller output losses in the face of external shocks. This was also the popular perception in the recent crisis—that it has been better weathered by countries with more flexible exchange rate regimes.

An extensive body of literature focuses on the implications of exchange rate regimes as stabilization instruments and credibility enhancers to examine the role of the exchange rate regime on inflation and growth performance. Overall, empirical evidence on exchange rate regimes and growth is mixed, with some studies finding positive effects of exchange rate flexibility and others claiming that countries with pegged exchange rates—especially hard pegs—grow faster.¹ For example, Ghosh et al. (2002) find that intermediate (neither rigidly fixed nor freely floating) regimes have a positive effect on growth, but also find some evidence that pegged regimes are associated with greater output volatility. Distinguishing by level of development, Levy-Yeyati and Sturzenegger (2003) find that floats are associated with slower growth and greater output volatility in developing countries, and that pegged and intermediate regimes negatively impact growth of EMEs. In contrast, Husain et al. (2005) find that pegs are associated with higher growth in developing countries, but have no effect on the growth performance of EMEs. Finally, Ghosh et al. (2010b) find that intermediate regimes are associated with fastest output growth particularly in EMEs, while pegged and intermediate regimes are associated with deeper trade integration, which is also growth-enhancing.

With changes in the economic environment—including collapses of pegs and managed floats in Asia and Latin America, and sudden stops or reversal in capital inflows—the debate shifted to how different exchange rate regimes can act as shock absorbers of external shocks and how they can shield countries from speculative attacks. Investigating the optimal policy response to a financial crisis, Aghion et al. (2004), and Lahiri and Vegh (2007) conclude that contractionary monetary policy results in greater output loss, while Cespedes et al. (2004) and Curdia (2007) find that a flexible exchange rate regime is the optimal exchange rate policy during a currency crisis. Investigating the effects of monetary and fiscal policies on output growth during sudden-stop crisis in emerging markets and developing countries, Hutchison et al. (2010) find smaller output losses associated with fiscal expansion, no discernable effect of monetary expansion, and no evidence that the de facto exchange rate regime has an effect on output following a sudden stop.

Contractions during crises are followed neither by a fast recovery nor a recovery in trend output. Cerra and Saxena (2008) find that output losses after financial and political crises are large and highly persistent, while Abiad et al. (2009) conclude that initial conditions have a significant impact on output losses after financial crises, and some mixed evidence that real exchange rate depreciations are associated with smaller output losses. In addition, Gupta et al. (2007) find that economies receiving substantial capital flows in the years prior to the crisis are more likely to experience a contraction during the crises, and that relationships between the explanatory variables and output growth differ substantially in the crisis and non-crisis years. Finally, Reinhart and Rogoff (2009a,b) summarize lessons learned from financial crises across the world during the last 800 years. They document recurrent patterns and conclude that financial crises repeat, and generally conclude that, historically, recoveries following financial crises take a very long time.²

Very few empirical studies have examined the output collapse during the recent global financial crisis. Berkmen et al. (2009) examine the crisis impact using revisions of growth forecasts and find that countries with financial vulnerabilities experience larger downward growth revisions. They also find that the financial channel is more important than the trade channel for EMEs (while the trade channel seems to matter more for developing countries) and that exchange rate policy explains a large share of the variation in the growth forecast revisions. Focusing only on EMEs, Blanchard et al. (2010) examine cross-country quarterly growth rates during the acute part of the global financial crisis, as well as several case studies. They find that while the crisis spread to EMEs through both trade and financial channels, the financial channel played a more important role and that there is little direct effect of the exchange rate regime or reserve accumulation in limiting the decline in output growth during the crisis.³ None of these papers, however, examines the post-crisis recovery, and none focuses explicitly on the role of exchange rate regimes.

In this paper, we examine if the exchange rate regime played any role in affecting output during the recent crisis and recovery in EMEs, while controlling for potential determinants influencing growth in each episode. We focus the discussion on EMEs given their importance in world growth, the diverse pattern of growth loss across EMEs during the crisis, and the fact that they constitute a homogenous sample.⁴ In addition to identifying differences among pegs and non pegs during these two episodes, we examine the role of other factors that influenced performance during the crisis and are currently underpinning the recovery such as monetary and fiscal policy. In this respect, our paper—the first attempt of its kind, to the best of our knowledge—contributes to the ongoing debate by examining growth episodes in EMEs covering both the crisis and recovery periods to assess how the choice of exchange rate regime can help explain how EMEs fared in, and are recovering from, the recent crisis.

Our main findings can be summarized as follows. *First*, during the crisis, taking into account regime switches, using alternative definitions to classify pegs, and controlling for other likely determinants, growth performance for pegs was not

¹ If exchange rate policy is effectively monetary policy—which is neutral in the long run—this finding is perhaps not surprising. However, in the context of hard pegs (currency unions) it can be argued that a common currency lowers currency risk and interest rates (which spurs investment and growth). Also, lower transactions costs due to common currency are associated with increased trade (see, for example, Rose (2000)), which also increases growth.

² However, there have been some concerns about using results from by Reinhart and Rogoff's analysis to explain developments in the world economy. In addition to the critique that little economic theory is offered to accompany the findings, Bernanke (2011), and Gagnon (2009) point out that the role of policy response and its adequacy is ignored in Reinhart and Rogoff's analysis. Also, López-Salido and Nelson (2010) suggest a different postwar chronology of financial crises compared to that by Reinhart and Rogoff, and they find that the regularity that recoveries are slower following financial crises does not hold for the postwar United States.

³ Other studies that attempt to explain the differences in the crisis impact across EMEs include IMF (2010), Ghosh et al. (2010a,b), Rose and Spiegel (2009), and Taylor (2009).

⁴ See Appendix A, Table A1 for the list of countries in the sample, which is based on the sample of EMEs covered in the IMF's Early Warning Exercise (IMF, 2010).

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