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Surprising similarities: Recent monetary regimes of small economies

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ABSTRACT

In contrast to earlier recessions, the monetary regimes of many small economies have not changed in the aftermath of the global financial crisis. This is due in part to the fact that many small economies continue to use hard exchange rate fixes, a reasonably durable regime. However, most of the new stability is due to countries that float with an inflation target. Though a few have left to join the Eurozone, no country has yet abandoned an inflation targeting regime under duress. Inflation targeting now represents a serious alternative to a hard exchange rate fix for small economies seeking monetary stability. Are there important differences between the economic outcomes of the two stable regimes? I examine a panel of annual data from more than 170 countries from 2007 through 2012 and find that the macroeconomic and financial consequences of regime-choice are surprisingly small. Consistent with the literature, business cycles, capital flows, and other phenomena for hard fixers have been similar to those for inflation targeters during the Global Financial Crisis and its aftermath.
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1. Introduction

The global financial crisis (hereafter "GFC") of 2007–9 began and was felt most keenly in the rich Northern countries. Nevertheless, much of its effect was felt abroad; the great recession of 2008–09

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was a global affair. Small economies were indirectly affected as the shock waves spilled out from New York and London, most dramatically in the form of contractions in the international flow of capital and trade. My interest in this paper is comparing how the outcomes for small economies varied by their choice of monetary regime. I am particularly interested in contrasting two monetary regimes: hard exchange rate fixes, and floating with an inflation target. Both are well-defined monetary regimes that are widely used by small economies around the world. The two regimes are also quite different, potentially providing a sharp comparison. Did one monetary regime provide more insulation from the GFC than the other?

The Great Recession associated with the GFC was the most dramatic macroeconomic event in generations; as Imbs (2010) convincingly demonstrates, it was also the first truly global recession in decades. Historically, recessions have frequently caused monetary upheaval; change in monetary regime has been strongly counter-cyclic. Yet this time has been different, at least for the two monetary regimes of concern here. Most countries with hard fixed exchange rates in 2006 (before the onset of the GFC) still retained them in 2012. More striking though was the performance of the inflation targeters; while the tactics of flexible inflation targeting regimes have varied with quantitative easing, forward guidance and the rest, the fundamental monetary strategy has not; no country abandoned inflation targeting.[3]

Interest in academic studies of currency crises (typically when a fixed exchange rate is abandoned) has greatly diminished over the last fifteen years. A number of small economies whose experiences spawned important academic research are now sufficiently stable as to be boring, including (at the very least) Brazil, Chile, Korea, Mexico, Sweden, Thailand, and Turkey. The common element in the transition from newsworthy to stability is the adoption of a monetary regime of a floating exchange rate with an inflation target. While before 2007 there were legitimate questions about the durability of inflation targeting, it has now withstood a substantial trial by fire.[4] Between the hard fixes and inflation targeters, most of the international monetary system has withstood the pressures of the GFC and its aftermath in at least one critical aspect: it has preserved itself.

My analysis in this paper is broad in the sense that I analyze a number of macroeconomic phenomena for more than 170 small economies. My focus is also narrow: I am most interested in the period since 2006, and I am interested in the effects of the *monetary* regime, primarily on the way international capital flows were handled.[5] My quantification of the monetary regime relies on a comprehensive classification of *de facto* behavior, gathered by the IMF.

I have two major results. First, monetary regimes have remained stable and unchanged during the GFC and its aftermath for a large number of countries, those of hard fixers and inflation targeters. The recent finding of monetary stability contrasts with earlier periods; historically, countries have switched their regimes counter-cyclically, that is especially during recessions. Since there are now two reasonably stable monetary regimes available to small economies which appear to be starkly different, it is natural to ask which has performed better, especially during the turbulent period since 2006. In practice this question is hard to answer: while both hard fix and inflation targeting countries have experienced (for instance) lower inflation than other countries, the business cycles, capital flows, current accounts, government budgets, real exchange rates, asset prices and so forth do not seem to vary significantly between the two regimes. Thus my second major result is that the recent macroeconomic and financial performance of small countries with hard fixed exchange rates is similar to that for countries which float with an inflation target. At first blush, this seems surprising, since a hard commitment to an exchange rate fix seems quite different from the constrained discretion of an inflation target. However, the result is actually quite consistent with the literature which has been generally unable to find strong consequences of the regime, except for exchange rate volatility.

[3] Except to enter EMU; more on that caveat below.

[4] This is consistent with much of the analysis in Reichlin and Baldwin (2013) who write "'Flexible inflation targeting has survived the test of a major financial crisis well' writes Charles Wyplosz summing up a view broadly held by the authors."

[5] As Svensson (2010) argues "… financial-stability policy and monetary policy are quite different, with different objectives, instruments, and responsible authorities, the latter with considerable differences across countries. This does not mean that there is no interaction between them."

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