

# **The choice of exchange rate regime and the real sector. What can we learn from the experience of transition economies?**

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Non-technical summary

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The choice of an exchange rate regime is one of the key economic policy choices. After the wave of financial crises in the 1990s, the introduction of the euro and in view of euro-zone enlargement by new members from Central and Eastern Europe (CEE), this choice is not only an academic bone of contention, but also a real policy dilemma. The decision on the exchange rate system is affected by many considerations, ranging from economic arguments related to the stabilisation properties of regimes, existing institutional frameworks, trade and investment concerns, to political arguments pertaining to political preferences in given international contexts.

Half a century after Friedman formulated his hypothesis of a flexible exchange rate as a facilitator of adjustments in an economy characterised by nominal rigidities, there is still much controversy concerning the optimal choice of regimes for particular countries or groups of countries. After the collapse of the Bretton-Woods architecture of fixed exchange rates in 1973, real exchange rates became more volatile. At the same time, this volatility did not result in any directly observable changes in other real variables. This finding is generally viewed as surprising. This paper addresses the question whether the choice of an exchange rate regime impacts on the performance of the real sector of the economy.

Theoretical and empirical investigations into exchange rate regimes to date have dealt primarily with aggregate variables and have paid little attention to sectoral issues. This is surprising given that the distinction between tradables and nontradables has important implications for thinking across a whole range of issues in international economics. While this distinction emerges naturally in discussions of real exchange rates, the question of the differential impact of exchange rate regimes on the relative performance of sectors of the economy producing tradables and nontradables has been neglected. This is an important shortcoming of the literature given that nontradables comprise a predominant share of most economies. Against this background the focus of the presented paper is on sectoral analysis.

The detailed critical survey of both theoretical and empirical literature dealing with the sectoral dimension of the exchange rate regime debate presented in this paper demonstrates that there is no commonly accepted theory of exchange rate systems. Predictions of existing models depend crucially on specific assumptions concerning in particular the parameters of the utility function, the nature of the price adjustment process, characteristics of analysed shocks and openness of economies. This brings us to the point that theoretical models do not provide straightforward policy recommendations on the exchange regime choice.

Various econometric techniques (vector autoregression, pool mean group estimation, comparison of volatility measures) are used in the empirical part of the paper. Estimations are conducted for seven CEE countries (Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovak Republic and Slovenia) using the database for the period from the first quarter of 1993 to the last quarter of 2002.

The conducted empirical analyses do not identify robust evidence of differences between exchange rate systems in terms of reactions to shocks for tradables and nontradables. Furthermore, average volatility of sectoral output and prices relative to aggregate output and price index turns out to be equal between exchange rate regimes. We interpret this finding as a confirmation of results for developed countries, where the real effects of choosing exchange rate regimes are hardly detectable at the aggregate level. It is worth stressing that if real economy differences between exchange rate regimes exist they should be more pronounced at a disaggregated (i.e. sectoral) level.

Another finding is that in the analysed sample the trade weighted nominal effective exchange rates exhibit equal or even somewhat higher volatility under the fixed exchange rate regime as compared to floating. This appears to contradict both the intuitive expectations as well as evidence from industrialised economies. The lesson that emerges from this analysis is that pegged exchange rates do not seem to shelter a country from nominal or real effective exchange rate volatility if a country trades with economies whose currencies are volatile against the domestic country's anchor currency.

The lack of any serious impact of the exchange rate regime on the real economy suggests that the focus of the debate on optimal choice of exchange rate systems should concentrate on consistency of the monetary policy framework instead of restating standard arguments in favour of either fixing or floating exchange rate regimes. This debate should also take into account existing institutional arrangements and credibility issues. It is evident that exchange rate regime fit, be it peg or floating, to the overall macroeconomic framework matters for countries' development and stability prospects.