# EXCHANGE RATE REGIME AND MACROECONOMIC STABILITY. A LITERATURE SURVEY

**Ph.D. Student Patricia Amalia MERCEA (HANDRO)**
University of Craiova, Romania
E-mail: patricia.handro@yahoo.com

***Abstract:*** *Globalization and short-term capital inflow volatilities generate challenges for policies and countries, as well as for global and regional markets. An appropriate exchange rate policy tool, complemented by reserve accumulation, macroprudential measures and, when needed, capital control is some of the instruments that could produce effective safety nets and macro stability. A conclusion of our research is that flexible regimes are preferred by developed countries, with credible institutions that rely on deep capital markets. Emerging economies with unreliable institutions prefer stability as the fixed rate gives credibility and the macroeconomic stability can be achieved without best macro conditions.*

***Key words:*** *Exchange rate, Exchange rate volatility, International Trade, Stable Growth, Macroeconomic stability.*

***JEL Classification:*** *F43, F31, E42.*

## 1. Introduction

Due to globalization process, we are facing an increased transmission of shocks (monetary, commercial, solvency, liquidity, operations, cyber attaks). The strength of the economies as well as their choise for fixe or less rigide exchange rate is correlated with the development stage of the economy and other drivers summarised by IMF (1997). Most of the Emerging Markets Economies (EMEs) adopted inflation targeting, combined with controlled floating- as opposed to Advances Economies (AEs) that have opted for free-floating regimes.

The subject is particularly important given that the Mondial economy confronted high and persistent fiscal deficits, currency's war (devaluated currencies to enhance external competitiveness) and trade war. When fiscal policy is restricted by massive government debt and interest rate are very low, the economic policy purpose are moving toward reducing the exchange rate. Competitive depreciation is a zero-sum game because states try to steal their demand for each other.

## 2. Objectives

The paper identify the key role of international trade, assimetric shocks and financial sector development as transmission channel that might generate stability and more growth.

## 3. Methodology

We performed a literature survey based on previous studies that treated the subject of the relationship between exchange rate regimes and macrostability, based on the articles published on this area and working papers.

## 4. Analyses

Previous studies that focused on this subject find low evidence on the link between exchange rate and macrostability. Ghosh, Gulde and Wolf (2002) using an exhaustive dataset of one hundred forty countries find that inflation is lower and stable under fixed regimes but growth variation is almost the same under both regime (flexible or pegged). Furthermore Edwards and Levy-Yeyaty (2005) concluded that flexible exchange rate promote growth. Schnabl (2007) identifies three main transmission channels (trade, capital flows and macrostability) that transpose the exchange rate stability in more growth. Hussain et al. (2019) using a Non-linear Autoregressive Distributed Lag (N.A.R.D.L.)

model assert that the objective of macrostability is sustained by exchange rate management and strong currency.

***Research Results and Discussion***

This section focus on the overview of essential transmission channels that generate a stable growth and finally macroeconomic stability.

(i) Asymmetric shocks

Flexible exchange rates have been a necessary tool to cushion the economy with the impact of asymmetric shocks (Friedman, 1953). Mundell (Mundell, 1961) extended the theory of shock absorption (with the argument pro monetary union) McKinnon (1963) identify that small open economies that face nominal shocks prefere fixed exchange rate and the key role of the size of tradable sector. Stable exchange rate witch foster investment and consumption environment through the welfare effect originate in macroeconomic stability. From this perspective, Mundell (2002, 1973) later works consider that in small open economies, growth is enhanced when there are low exchange rate fluctuations. Furthermore, Aghion (2009) assert that shocks are stronger in countries with underdeveloped financial system.

The recent literature asserts that the broad portfolio flows modified the traditional role of flexible exchange rate (shock absorbent), which become a transmitter and amplifier of financial shocks instead e.g. (Gabaix and Maggiori, 2015; Bruno and Shin, 2015; Carstens, 2019). Robust appreciation of exchange rate is associated with increased credit supply from external investors, lowing the bond yields and reverse mechanism action when exchange rate depreciates (Hofmann, Shim and Shin, 2019). Moreover, a sharp depreciation might sharply raize term premia, affecting financial stability. Recent studies identify external borrowing from both capital market and banks reinforce each other as the financial crisis was preceded by substantial credit expansion and keen appreciation of exchange rate (Borio, McCauley and McGuire, 2011; Borio and Lowe, 2002; Gourinchas and Obstfeld, 2012).

(ii) International Trade and investments

Eliminating the foreign exchange risk (volatility) and the transactional costs stimulate international trade. At the microeconomic level, volatility is transposed in additional transactions costs (IMF, 2004, 1984). Moreover, Fixed exchange rates increase international price transparency (indirectly) because consumers can compare more easily prices from different economies.

The macroeconomic measure of exchange rate impact is described by long-term fluctuations that affect the level of competitiveness for domestic export industries. The small open economies and even large, closed economy export is influenced by large exchange rate fluctuations (McKinnon and Ohno, 1997; Mckinnon and Schnabl, 2004). How uncertainty disturb the trade option, its expected profitability, and the allocation of factors between tradable and non-tradable sector, was the future primary debate.

IMF (2004) conclude that there is no evident negative influence of volatility on trade excepting bilateral trade argued by the Asian crisis. Bacchetta and Van Wincoop (2000) consider that monetary stimulus in a country (exchange rate depreciation may not influence trade), because the increase in domestic demand may boost imports and offset the negative impact.

International macroeconomics focus on the role of competitive devaluation (undervaluation of currency) e.g. (Rodrik, 2008; Auboin and Ruta, 2011; Nicita, 2013; Bussière, Saxena and Tovar, 2012; Ozturk and Kalyoncu, 2009) assuming that it stimulate growth. The channel that contribute is the size of tradable sector (industry mostly).

However, US imports are less sensitive to bilateral exchange rate fluctuation (Gopinath et al., 2019).

Similarly, the macroeconomic theory describes the J-curve effects. E.g. P. Krugman (1991) explain the J- curve mechanism for long term USD devaluation from 1985s, Cairncross and Eichengreen (2003) describe the effects of sterling devaluation from 1967s.

The very recent literature underlines the role of USD as the dominant currency in global trade and emphasise that the strength of USD is associated with increase in global trade (Boz, Gopinath and Plagborg-Møller, 2017; Gopinath et al., 2019). Paradoxically, the competitive devaluation, dampened country exports (Bruno, Kim and Shin, 2018; Gopinath et al., 2019). Working capital for production chains acts as an incentive/contractor of the components of the value chain (Kim and Shin, 2012; Kalemli-Ozcan et al., 2014).

The conclusion is that volatility exerts a small negative impact influenced by the availability of hedge contracts, the production structure, the level of integration. However the traditional role of trade is diminished in our days.

(iii) Capital Markets

Mundell (1973), Mundell (2002) emphasizes the substantial role of capital markets that received an vital role in the exchange rate stabilization mechanism in our days (Aghion et al., 2009).

Fixed exchange rates (short term) might foster economic growth if transaction costs are removed (McKinnon, 2010). Without international capital market segmentation, debtors in EMEs win from lower interest rates (Dornbusch, 2001). The authorities have an incentive to stimulate these capital inflows (providing efficient financial supervision) in order to finance the current account deficit.

The capital markets developent influences the foreign exchange intervention. Countries with highly developed capital markets intervene on the long-term exchange rate. In contrast, EMEs with undeveloped financial system perform long-term and short term interventions (Chmelarova and Schnabl, 2006).

## 5. Conclusions

Effect of the fixed and flexible rates on economic growth was investigated, and it was argued that stable exchange rates are associated with higher growth The flexible regimes are preferred by developed countries, with credible institutions that rely on deep capital markets. Contemporary empirical studies further demonstrate that flexible regimes can act as a shock absorber in the event of trade tensions or global interest rate shocks without altering the asset sector or labour market. Also fixed exchange rates lead to higher growth in bilateral trade and have significant influences in stabilizing and reducing inflation. Emerging economies prefer stability as the fixed rate gives credibility and the macroeconomic stability can be achieved without best macro conditions.

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