THE INFLUENCE OF EXCHANGE RATE REGIMES ON ECONOMIC GROWTH: A MULTICOUNTRY EXAMINATION

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ABSTRACT

This paper evaluates the ability of exchange rate regimes to influence economic growth. Exchange rate regimes for 186 countries were classified into four categories. For the full sample, exchange rate regimes increased economic growth although inflation reversed the increase in economic growth, both for the full sample, and for developed countries. For developing countries, during the historical time period, all of the classifications increased economic growth with increasing flexibility of the exchange rate regime. For the modern period, developed countries displayed similar significant relationships, as did high, middle, and low income countries, small island states, and inland states.

***Keywords**: exchange rate regime, economic growth, developing countries, developed countries, fixed exchange rate, flexible exchange rate*

1. INTRODUCTION

Rodrik (2008) found that undervaluation of the exchange rate increases economic growth. Undervaluation of traded goods arises from poor contractual enforcements among suppliers, management, and other stakeholders, along with hold-up problems, corruption, long learning lead times for technological implementation, and credit market imperfections for new projects. The exchange rate values traded goods at world market prices, so that it increases the value of hitherto undervalued traded goods. Countries shift resources into the production of traded manufactured goods, leading to higher productivity in the production of traded goods. Higher productivity of labor leads to higher productivity in the export of manufactured goods, leading to export-led economic growth (Krueger, 1998).

A special case of exchange rate effects on economic growth is the distinction between fixed and flexible exchange rate regimes. With a fixed exchange rate regime, the central bank or other monetary authority sets exchange rates, so that the prices of MNC-produced traded goods may not reflect actual market prices. The impact of exchange rates on economic growth in such environments is unclear. Price distortions are less likely with flexible exchange rate regimes, wherein market forces determine exchange rates, and in turn, the prices of traded goods. We examine this impact of exchange rates on economic growth by evaluating the contributions of fixed and flexible exchange rate regimes to economic growth. We create a theoretical model, followed by panel data examination of 186 countries, during a historical time period from 1974-2009, and a modern time period from 2010-2018. In contrast with much of the literature that views fixed and flexible exchange rates as a dichotomous either/or 2-state choice, we explore a variety of exchange rate regimes with varying levels of fixedness and flexibility.

This paper contributes to the literature in three ways. First, our model perceives economic growth as a function of monetary policy adjustments to shocks undertaken by the central bank, exchange rate adjustments. The fixed exchange rate reduces uncertainty and nominal exchange rate volatility, thereby increasing the investment rate (Ghosh et al., 1997). A special case of fixed rate regimes is that of oil exporters. Oil exporters have fixed rate regimes with symmetry in their demand shocks, from oil being the principal common export commodity for all OPEC members. The chief common demand shock for oil exporters is the decline in oil prices. Monetary action to sell US dollars or to purchase domestic currency may be taken to boost the value of the domestic currency.