

COMMENTARY

Surprising Similarities: Recent Monetary Regimes of Small Economies

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I want to thank the organizers for giving me the chance to comment on this paper and to participate in what has become a premier conference. I will separate my comments into three parts. First, I will summarize the main findings of the paper. Next, I will explain why the results are surprising. Finally, I will offer my best explanation for the findings and pose a couple of questions that I believe the analysis raises.

1. Summary of the Main Findings

Andrew Rose's assignment for this paper was to explore the outcomes for different types of monetary regimes in the wake of the global financial crisis. He excludes the five dominant economies and focuses on smaller economies. His analysis is very straightforward and he convincingly demonstrates two main results. The first is that most countries with hard exchange rate pegs or inflation targeting policies both sustained their monetary regimes during the crisis. This stability is historically unusual because, as he also shows, during past recessions it was very common for countries to abandon their monetary policy regimes. Second, he shows that a wide range of economic outcomes across the two regimes were very similar. The variables he considers include both aggregate macroeconomic indicators and financial measures.

The data he uses are all available on his website, and I did some analysis myself cross-checking the findings. My conjecture in re-examining the data was that the choice of a peg instead of inflation targeting depends on the characteristics of a country. So perhaps controlling for those characteristics directly would uncover some differences. I describe a specific example of this below, but ultimately I did not find any systematic patterns that overturn his conclusions.

Author's note: *All errors are my own and the views expressed are not necessarily shared with the institutions with which I am affiliated. I thank Yongcong Tang for excellent research assistance.*

2. Are These Results Surprising?

Andy writes, “while an absence of any large detectable differences across monetary regimes might seem bizarre to a monetary economist, it is almost folk wisdom inside international finance.” Let me side with the monetary economists and offer four reasons why these results are surprising and almost troubling.

First, a hard fix is a monetary policy rule, while flexible inflation targeting gives the monetary authority discretion. There is a vast literature on the merits of adopting rules versus exercising discretion in policymaking. Indeed, Mervyn King, who is arguably the father of inflation targeting, routinely argues that the whole point of inflation targeting is to implement constrained discretion (see, e.g., King 2004). I would guess with high confidence that most of the people who have supported inflation targeting did not think that they could have achieved the same outcomes by simply adopting an exchange rate peg.¹

Second, we do not think that monetary regimes are chosen randomly. As Rose demonstrates, prior to the crisis we often saw countries switch monetary regimes during downturns. One would expect that the countries that had been driven to a peg got there after experimenting with other monetary policy arrangements. Moreover, we would expect that the rules would emerge in specific circumstances. In some cases, the currency unions or pegs might have evolved because of historical accident relating to colonial arrangements. But outsourcing your monetary policy to another country via a fix would make the most sense when the country abandoning flexibility had institutional weaknesses that limited the benefits of retaining flexibility. Crudely put, if a country cannot find a competent central banker or cannot avoid interfering with the central bank, then that country might wind up with a peg. In that case, however, you would think that the underlying problems would still lead to bad economic outcomes during crises (when compared with countries that are organized enough to run a partially discretionary policy).

A third reason that these results are surprising is that countries that do adopt hard pegs often do not seem to be part of an optimal currency area with a country to which the peg is set. I doubt that most economists would suggest that interest rate policy for the West African countries that belong to the CFA should be set in Frankfurt. Yet with support from France these eight countries have pegged their currency to the euro. Likewise, Hong Kong and many countries in the Middle East have hard fixes to the dollar, despite the limited commonalities between their economies and the United States.

Finally, there is a vast amount of evidence that bad monetary policy matters for economic outcomes. So having your monetary policy set by a central

bank that pays no attention to your economy would seem to be a very risky policy to pursue.

Thus, while I recognize that Rose is correct in saying that past research has found results that are similar to what he reports, I do not think we should take the findings as self-evidently obvious. If anything, I would say that as a general proposition most economists would expect that inflation targeting and pegging would be expected to deliver dissimilar outcomes.

3. How Can We Explain the Findings?

After my first read of the paper, I was convinced that it must be the case that many of the countries that adopted hard pegs had problems with corruption or the rule of law. Thus, if we simply redid the analysis and controlled directly for these factors, we could isolate the countries with pegs for these reasons as the ones that have underperformed. Corruption is higher and standard proxies for rule of law are weaker on average in the countries with fixed exchange rates. But controlling for these factors did not overturn the conclusion that most of the economic outcomes that Rose considers look the same between the inflation targeters and the countries with hard fixes.

Upon further review, I switched to a different consideration. The crisis was not only a deep recession that brought strong deflationary pressure, it was also felt virtually everywhere. So in this particular case, for most countries a competent, independent central bank would have aggressively eased monetary policy. The inflation targeting countries were free to pursue such a policy. But for any country that had pegged to the dollar or the euro, they also saw policy ease because of the actions of the Federal Reserve and the European Central Bank. So during the crisis it seems that the risk of a peg delivering an inappropriate monetary response was not an issue. Under this interpretation the crisis is a special case from which we might not want to generalize.

One way to see this is to look at the experience of the oil-dependent countries in the Middle East (Bahrain, Jordan, Qatar, and Oman) which had pegged their currencies to the dollar. As Table 1 shows, oil prices from 2002 through 2007 had nearly tripled, and through the summer of 2008, oil prices were still rising. The U.S. economy had been slow to recover from the 2001 recession and inflation was contained, so the Federal Reserve only began raising interest rates in 2005. Consequently U.S. monetary policy was not likely to be the one that these oil-dependent countries would have chosen. As the table also shows, inflation in the Arab countries was consistently rising, and in 2008, when the Fed had already responded to the onset of the U.S. recession by cutting interest

TABLE 1
Inflation, Interest Rates, and Oil Prices

Year	Federal funds rate (%)	US CPI inflation (%)	Bahrain, Jordan, Oman, Qatar average CPI inflation (%)	Brent oil prices (US\$)
2002	1.67	1.6	0.5	24.99
2003	1.13	2.3	1.8	28.85
2004	1.35	2.7	4.2	38.26
2005	3.21	3.4	5.0	54.57
2006	4.96	3.2	6.7	65.16
2007	5.02	2.9	7.5	72.44
2008	1.93	3.8	11.2	96.94
2009	0.16	-0.4	-0.9	61.74
2010	0.18	1.6	1.5	79.61
2011	0.10	3.2	2.0	111.26
2012	0.14	2.1	3.1	111.63

Sources: World Bank Development Indicators and Federal Reserve Bank of Saint Louis FRED database.

rates, we see that inflation exceeded 11 percent. As the crisis raged, oil prices dropped, and in 2009, inflation in the Arab countries also retreated.

I read this evidence as saying that monetary conditions in the crisis still mattered. For most countries super loose monetary policy was appropriate. But in the rare case, like these four countries, where this was not the best policy, the usual problems arose. So I do not think we can conclude that monetary arrangements are simply irrelevant or that success of the hard fixers is inevitable.

Instead, I wonder if the findings in this paper would be obtained in more normal circumstances. Suppose global conditions are not synchronized so that, for instance, the Federal Reserve and European Central Bank interest rates are moving differently. Will the countries that have pegged fare equally regardless of which of the two they have pegged? Another way this could manifest is if the major central bank decisions about when to begin normalizing policies from the extraordinary ones that are in place are asynchronous. Will that have benign effects?

Coincidentally, we may soon get an out-of-sample test of the premise of the paper. The aforementioned members of the West African currency union have announced their intentions to move to a new currency, the eco, which will no longer be tied to the euro and will eventually be enlarged to include a number of other countries.² Nigeria is slated to be one of the new members of the full union. Nigeria's GDP is three times larger than the current members of the bloc, and its heavy oil dependence has meant that its business cycle historically has been disconnected from the others. I am betting with the monetary economists that if this comes to pass, the hard fix will lead to hard times.

REFERENCE

King, Mervyn A. 2004. "What Has Inflation Targeting Achieved?" In *The Inflation Targeting Debate*, eds. Michael Woodford and Ben S. Bernanke. Chicago: University of Chicago Press, pp. 11–16. <http://www.nber.org/chapters/c9554>

NOTES

1 Of course, the analysis in this paper sets aside the five large economies. So perhaps one might conclude that if most of the large economies tried to peg to one of the others, the results would not be good. But, I still believe that the proponents of inflation targeting would expect it to deliver superior outcomes relative to a peg for most small countries.

2 See "Currency Unions in Africa: Ever Closer," *The Economist*, December 7, 2013. <http://www.economist.com/news/finance-and-economics/21591246-continent-mulls-merging-currencies-ever-closer>