

Financial Markets and Exchange Rate Regimes in Transition to EMU

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Abstract

This paper highlights that the European Economic and Monetary Union (EMU) transition process itself can pose challenges to individual accession countries and draws policy implications for ERM II. Differences in financial market development and international liabilities underscore the risks and benefits of ERM II, and may lead to conflict between short and long-term policy objectives.

Policy Problem

Since the introduction of the euro in 1999, sixteen European Union (EU) member states have adopted the common currency as of 2008. Eleven member states still remain less than full participants of the EMU.

Borghijis and Kuijs (2004) have found that the exchange rate has been a counterproductive propagator of shocks in Central European accession countries, and therefore joining the monetary union would entail little opportunity cost. Lopez and Chacon (2006) confirm this finding for Hungary, but show that the exchange rate serves as a stabilizing tool in the Czech Republic and Poland. Hence, delaying EMU entry and retaining monetary independence could be a more viable option for the Czech Republic.

As one of the preconditions of entry into the eurozone, potential entrants are required to adopt successfully the framework of the Exchange Rate Mechanism (ERM) II for a minimum of two years. ERM II stipulates the maintenance of a stable exchange rate peg vis-à-vis the euro, typically with a fluctuation margin no greater than +/- 15%. The ERM II participants are mostly made up of smaller new EU member states. Some of the larger economies – such as the United Kingdom, Poland, Czech Republic and Hungary – have not entered ERM II. While their individual circumstances and motivations vary, this paper provides a unifying framework for analyzing the incentives to enter ERM II as a decision distinct from the goal of adopting the euro.

References

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Determinants of Regime Choice

In practice exchange rate regimes exhibit a large degree of heterogeneity even within the same official category. Fixed exchange rates get realigned frequently or fluctuate in a relatively wide band, while some floats behave more like a peg. This observation led to a thorough re-examination of exchange rate regime classifications, and differentiation between *de jure* and *de facto* regimes.

The Czech Republic and Hungary provide an interesting ground for comparison, since they are similar in size and share a common past of central planning, yet they exhibited significant divergence in their choice of economic policy both historically and during the transition period of the 1990s. Different paths of public debt and inflation had significant implications for the sources of investment financing. The paper attributes the choice of exchange rate regime to the development of these underlying factors.

Implications

Utilizing a comparative study of two recent EU entrants and aspirants for full EMU membership this paper highlights the potential pitfalls in the transition to EMU, specifically with respect to the required two year participation in ERM II.

This paper suggests that the framework of ERM II should be reconsidered in light of the new challenges that potential euro-area entrants face. The width of the exchange rate band under ERM II had been changed once previously in 1993 when participating currencies came under attack. In an environment characterized by large and volatile capital flows, maintaining an explicit exchange rate band can be quite costly. An alternative could be to support a target band of +/-15%, but without the explicit obligation to intervene to preserve the peg. Greater uncertainty about intervention to defend the band would likely discourage speculative attacks, while the criterion of exchange rate stability could be still assessed on a case-by-case basis for new entrants.

Government size and openness revisited: The case of financial globalization

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Abstract

The volatility of international capital flows to emerging markets has been well documented. Financial globalization may not in general fulfill its theoretical role as a risk sharing mechanism in financially underdeveloped economies, and hence may provide an impetus for compensating government spending. This paper investigates the relationship between government size and financial openness for 87 developing and developed countries between 1976 and 2003.

Research Problem

Comparative studies of the public sector have provided evidence of a robust positive association between government size and openness of the economy to trade flows. Cameron (1978) provided empirical evidence for a sample of OECD countries over the period 1960-75 that government size increases with openness to trade flows. Rodrik (1998) reintroduced and documented the hypothesis that government spending plays a risk-reducing role in open economies. Extending the analysis of openness and government size to financial openness is the logical next step.

Widespread capital account liberalizations implemented since the 1990s have been accompanied by several financial crises that highlighted the pitfalls of financial volatility and their contagious character around the globe. As Liberati (2007) argues, it is a matter of empirical investigation to determine the net effect of two opposing forces associated with globalization on government size: on one hand increasing demand for government expenditure to smooth out fluctuations in the economy associated with external shocks (the compensation hypothesis), and diminishing taxation capacity by governments due to enhanced capital mobility on the other (efficiency hypothesis).

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Methodology

Previous research has analyzed the links between financial integration and government size in a small set of industrialized countries or has a short horizon. The research addresses this problem by analyzing a large sample of developed and developing countries during the rapid expansion of private international capital flows in the 1980s and 1990s. It also controls for a wide range of other macroeconomic, demographic and political/institutional determinants of government size in analyzing the impact of openness. Robustness checks using the Arellano-Bond (1991) generalized method of moments estimator allow us to further account for potential endogeneity problems by treating some of our explanatory variables as endogenous.

Findings

Trade openness remains statistically significant with a positive sign confirming the findings of Rodrik (1998). Among other variables, real GDP per capita, age dependency ratio and population size fail to exhibit statistical significance. Parliamentary systems are associated with bigger governments, a finding consistent with theoretical predictions by Persson and Tabellini (1999).

Financial openness represented by gross private capital flows as percentage of GDP is a statistically significant explanatory variable at the 1% level under all model specifications. Economies with greater exposure to cross-border capital flows tend to have larger government size. Moreover, the interaction term of financial openness and per capita GDP is also highly significant and reveals that richer financially open economies tend to have smaller governments. These findings are consistent with the hypothesis that benefits of financial integration through improved risk-sharing and consumption smoothing accrue only beyond a certain level of financial development.