

COMMENTARY

## Surprising Similarities: Recent Monetary Regimes of Small Economies

Frederic S. Mishkin

### Overview

Andy Rose's paper provides important evidence on the impact on how monetary regimes fared during the recent global financial crisis. The paper has two basic results.

First, it shows that the two monetary regimes, hard fixing and inflation targeting, have become surprisingly durable and were able to withstand the stress of the shocks from the global financial crisis. Before the global financial crisis, monetary regime changes were countercyclical, that is, switches in regimes occurred more often during bad times, and particularly when countries were hit by major crises. The response of hard fix and inflation targeting regimes did not display this countercyclical pattern because countries stuck with them in the aftermath of the global financial crisis, even in the face of huge negative shocks. This was especially true for the inflation targeting regime: Not one of the inflation targeting countries dropped this monetary regime, unless they dropped it to enter the euro zone, and the reasons for entering the euro zone had little to do with the success or lack of success of inflation targeting. Countries that dropped inflation targeting to adopt the euro did so to become more fully part of the European project, and this was a political decision not a monetary one.

The second result in Rose's paper is that from 2007–12 outcomes in terms of many macroeconomic variables were surprisingly similar for countries with hard fix and inflation targeting regimes, while outcomes for the regime he calls the sloppy center were quite different, particularly on the inflation front, where inflation performance was substantially worse.

The empirical analysis is well done and pretty convincing and is not bizarre, at least to this monetary economist. But how should we interpret the evidence? Does it suggest that the monetary regime doesn't matter? I will argue that the

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**Author's note:** *The views expressed here are my own and are not necessarily those of Columbia University or the National Bureau of Economic Research. Disclosure of my outside compensated activities can be found on my website at <http://www0.gsb.columbia.edu/faculty/fmishkin/>*

answer is a strong no. However, I will also argue that the evidence in the paper suggests that a key feature of a monetary regime is not whether it is a fixed versus a flexible exchange rate regime.

## Empirical Issues

Before discussing the above, I do want to raise some concerns about the empirical analysis in the paper as is my duty as a discussant.

The first concern has to do with the classifications of the regimes. Inflation targeting regimes are pretty well defined because most countries adopting inflation targeting have converged to similar best practices. However, this cannot be said for the hard fix classification that Rose adopts, because it includes exchange rate pegs with possibly very different degrees of “hardness.” Exchange rate regimes that have a strong statutory framework are clearly hard fixes. These hard fixes are of two types: full dollarization or a currency board. A currency board has the domestic currency backed 100 percent by a foreign currency, and the note-issuing authority, whether it be the central bank or the government, fixes a conversion rate to this currency and stands ready to exchange domestically issued notes for the foreign currency on demand at this rate. A currency board is a hard fix because the commitment to the fixed exchange rate has a legal (or even constitutional) backing and because monetary policy is, in effect, put on autopilot and completely taken out of the hands of the central bank and the government. Full dollarization is an even harder fix because it involves a country dropping its own currency entirely and instead adopting a foreign currency (the U.S. dollar, but it could be another currency, such as the euro or the yen) as legal tender.

The hard fix classification that Rose uses includes conventional pegs and, as Rose mentions in his footnote 11, this “may raise the eyebrow here.” My eyebrows certainly did rise because conventional pegs just involve a government announcing an exchange rate peg, which it can abandon at any time. Nonetheless, conventional pegs, even though not written into law, can sometimes be quite hard. Denmark immediately comes to mind because it is so integrated with the euro zone, both economically and politically, and so, though not statutory, the commitment to the peg is very strong. This was similarly true in the past with a country like Austria that sustained its peg with the deutsche mark for 20 years until it adopted the euro. However, many conventional pegs may not have strong commitments behind them, and history has taught us that, in those cases, the pegs are easily abandoned and so were not strong.

Deciding on whether a conventional peg is hard or not is not at all easy to do, thus I do not have a recommendation for Rose on what he should do about

this. Nonetheless, given his expertise, I would like him to think more about this issue to see if there is some way to differentiate conventional pegs into hard versus soft pegs. Doing so would make the empirical work of the paper even more convincing.

The second comment on the empirical analysis is not a criticism, but the recognition that the empirical work in the paper is purposely very narrow. The empirical work finds that the hard fix and inflation targeting regimes have similar outcomes for only one type of shock: that is, a major financial crisis. It doesn't tell us that outcomes would not be very different for hard fix versus inflation targeting regimes from other shocks, in particular, terms of trade or inflation shocks.

The academic literature suggests that flexible exchange rate regimes can cushion terms of trade shocks. Australia's experience immediately comes to mind. With minimal exchange rate intervention, commodity price booms have led to appreciations of the Aussie dollar, which put a brake on the resulting economic expansion of the Australian economy because it led to expenditure switching. Similarly, the contraction of the economy was cushioned by the flexibility of the exchange rate when there were commodity price busts, which led to a depreciation of the Aussie dollar, thereby increasing the demand for noncommodity Australian goods and services. When you talk to Australian policymakers, they argue that the Australian economy became much more stable when they learned that it was a mistake to intervene to keep the Aussie dollar stable and so adopted a more flexible exchange rate regime. Indeed, the Australian move to a flexible exchange rate with inflation targeting is viewed as one of the great success stories of monetary policy regime change in the past 20 or so years.

A large literature (some of which I have contributed to) has documented that inflation targeting has proven to be very successful in containing inflationary shocks, especially for emerging market countries (e.g., see Mishkin and Schmidt-Hebbel 2007). The period of the global financial crisis that Rose examines experienced a worldwide, highly contractionary shock, rather than an inflationary shock. Hence the paper's evidence tells us nothing about whether, in an environment where inflationary pressures are the problem rather than a worldwide economic contraction, inflation targeting might produce better outcomes than conventional pegs.

## **What Defines a Good Monetary Regime?**

One way that the paper might be read is that monetary regimes don't matter much because hard fix and inflation targeting regimes had similar outcomes during the global financial crisis. However, this is not the lesson of the paper at

all, and this is why I did not find its empirical findings bizarre, as Rose suggests might be the case for many monetary economists. Instead it shows that monetary regimes matter a lot, but the key feature of a monetary regime is not fix or flex, as Miguel Savastano and I pointed out in a paper we published in 2001 (Mishkin and Savastano 2001).

Over the past 30 or so years, the academic literature has developed what has been dubbed the science of monetary policy (Clarida, Galí, and Gertler 1999), whose principle policy recommendation is that an effective monetary policy regime must have a strong nominal anchor, that is a commitment to keep inflation stable with a target for a nominal variable, whether it be the inflation rate as in inflation targeting, an exchange rate as in a hard fix, or the money supply as in monetary targeting. Indeed, as I point out in Mishkin (2011), nothing that occurred during the global financial crisis weakens the intellectual underpinnings for this conclusion from the science of monetary policy. In contrast to statements by some economists and media pundits, the events since 2007 strengthen the support for having a strong nominal anchor, because policies to counter the contractionary impact of financial disruptions require a strong nominal anchor to ensure that they do not lead to an unhinging of inflation expectations that could be very harmful to the economy.

The key feature of both hard fix and inflation targeting as monetary regimes is that they both embody a strong commitment to a nominal anchor. Indeed, as Rose's evidence indicates both of these regimes were able to keep inflation low and stable during the global financial crisis, with inflation 5 percentage points lower than was true for countries whose monetary regime was the squishy center.

However, there are two other key features required to make these monetary regimes successful. First is a regulatory system that ensures that financial institutions are safe and sound. If there is a failure of the regulatory system such that financial institutions take on excessive risk, even minor shocks can cause the financial system to seize up, resulting in a banking or general financial crisis. The impairment of financial intermediation during a financial crisis causes lending to contract, and thus leads to a fall in investment spending that causes a contraction in economic activity. In addition, the losses on bank and other financial institution balance sheets during a financial crisis can make it impossible for a country to defend its exchange rate. As a result, a currency crisis ensues, with a collapse of the value of the currency that can lead not only to a surge in inflation but also to further destruction of balance sheets, making the financial crisis even worse (see Mishkin 2006).

The second additional feature necessary for a successful monetary regime is strong fiscal institutions to ensure that government budget deficits do not get out of control. When weak fiscal institutions lead to an explosion in government debt, there are two possible outcomes. One is the possibility of sovereign debt default that causes domestic interest rates to surge, which helps produce a sharp contraction in the economy. The other is described as *fiscal dominance*, because the monetary authorities will no longer be able to pursue monetary policies to keep inflation under control because they will be forced to purchase (monetize) the government debt, leading to higher inflation (referred to by Sargent and Wallace (1981) as “unpleasant monetarist arithmetic”).

Note that there are possible strong interactions between weak financial institutions and fiscal dominance. Weak financial institutions during a financial crisis can lead to large government bailouts, as occurred in Ireland during the global financial crisis, that lead to huge budget deficits. On the other hand, fiscal dominance which leads to a sovereign debt crisis can lead to large losses on financial institutions’ holdings of government bonds, thereby destroying these institutions’ balance sheets, as occurred in Argentina during its 2001–02 crisis.

A tale of three countries—Greece, Spain, and Germany—during the global financial crisis illustrates that having a strong nominal anchor as in a hard fix or an inflation targeting regime is not enough to assure good outcomes. These three countries had very different experiences during the global financial crisis. Greece’s woes stemmed from its weak fiscal institutions that led to a sovereign debt crisis that has devastated its economy. Spain, on the other hand, did not run large budget deficits, but did have financial institutions that took on excessive risk during the boom period before the financial crisis. When its real estate market collapsed, its banks booked large losses, leading to a sharp contraction in lending and a deep recession, with unemployment rising to over 25 percent. Germany on the other hand, not only was fiscally responsible before the global financial crisis but also had financial institutions that were sufficiently strong to withstand the losses resulting from the global financial crisis. The result was that the German economy fared much better than many others in Europe.

## Conclusion

Andy Rose’s paper provides important empirical work that shows that the debate over monetary regimes should not be over fix versus flex, but rather should be how a monetary regime can be designed to have three key features: (1) a strong nominal anchor, (2) strong fiscal institutions, and (3) strong financial institutions.

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