

Test of an Inverted J-Shape Hypothesis between the Expected Real Exchange Rate and Real Output: The Case of Ireland

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Abstract

Applying an open-economy macroeconomic model, incorporating the monetary policy reaction function and uncovering interest parity, this paper finds that the expected real exchange rate and real output exhibit an inverted J-shape relationship, suggesting that expected real depreciation increases real output during 1999.Q2-2001.Q3 whereas expected real appreciation raises output during 2001.Q4-2009.Q1. Other findings show that a higher real financial stock price, a higher world real interest rate, or a lower expected inflation rate would increase real output. Fiscal prudence may be needed as the coefficient of the government borrowing/GDP ratio is insignificant at the 10% level.

Keywords: Expected Real Depreciation or Appreciation, Monetary Policy Reaction Function, Fiscal Policy, Financial Stock Price, Uncovered Interest Parity

JEL classification: E52, F31, F41, O52

1. Introduction

Known as the Celtic Tiger for more than a decade, Ireland had enjoyed rapid economic growth, budget surpluses, low inflation, low unemployment, and other positive developments. However, since 2008 Ireland's economy has been hit hard by the global financial crisis and world economic recession. According to the International Monetary Fund (2009), Ireland was faced with high dependence on construction, overvaluation of housing prices, over expansion of the banking sector, global competitive disadvantages, falling international market shares, high unit labor costs, declining share of FDI, risks associated with falling inflation, vulnerability in the financial sector, low interest margins, lack of growth in deposits, concentration of loan portfolios in residential mortgages, commercial properties, and real estate developments, and other challenges. According to the forecast for Ireland in 2009 made by the Economist (2009), its real GDP would suffer a decline of 7.7%, the government would have a budget deficit of 12.9% of GDP, and the current account balance would have a deficit of 3.1%. The short-term interest rate would drop to 1.4% from 4.6% in 2008. Due to a weak demand, the inflation rate would decline 3.6%.

This paper attempts to examine the roles of the expected real exchange rate and other related macroeconomic variables affecting output fluctuations. First, it incorporates

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