Floating exchange rates and emerging markets

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Some big questions about flexible rates

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- Monetary independence?
- Insulation properties
- Original sin and balance sheet effects
- How dirty a float?
- The global safety net

Monetary independence?

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- Given Mundell´s impossible trinity (the trilemma), if you give up exchange rate stability, you gain monetary independence
- Today we know that is not quite the case
- You do not have to be French to worry about the dollar cycle (Rey, 2013; Bruno and Shin, 2015; Shin, 2020; Miranda-Agrippino and Rey, 2022)
- It all goes back to Calvo, Leiderman, and Reinhart (1996): external factors determine capital flows
- In fact, a strong dollar predicts pretty much everything for EMs
  - Capital flows, credit conditions, output, consumption, investment…
- Yes, some EM countries loosen when the US tightens
  - But they are few
  - And they do so at their own peril

And yet….

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- Despite the dollar cycle, floating provides substantial insulation
- In response to a 10 percent dollar appreciation
  - “GDP, investment and the stock market fall more sharply for pegs”
  - Obstfeld and Zhou (2023)
- This is because a peg requires larger tightening in response
- Or, because shock raises required excess return on EM bonds
  - Under flex, this is achieved via depreciation; under fix, via rate spike
  - Kalemli-Özcan (2019)
- Or, because the old expenditure-switching story still matters

What happened to balance sheet effects?

- With original sin (dollar debt), a sharp depreciation..
  - Could wreck balance sheets and trigger a crisis
  - Could even be contractionary
- But this does not seem to have happened!
- Flexible rates seem to provide more insulation
  - Even under original sin and balance sheet problems (relative magnitudes)
  - Céspedes, Chang and Velasco (2004)
- Or, because balance sheet composition is endogenous
  - Under credible flex, less debt, more domestic currency debt, more hedging
  - Chang and Velasco (2006)
- Note: original sin has not disappeared (80 percent of debt in dollars)
- Could even have “original sin redux” (Carstens and Shin, 2019)

Why the dirty floats?

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- Under inflation targeting..
  - Interest rate is supposed to be targeted at inflation and the output gap
  - And the exchange rate is supposed to float freely
- But on planet earth…
  - Almost all inflation targeters intervene
  - And EM inflation targeters hold huge reserves
- The Catholic approach to exchange rates?
  - Promise to do one thing
  - But quietly do something else
- Interventions “when exchange rate is strongly misaligned” only
- Why? Is it indeterminacy? Bubbles? Hyper-depreciation paths?
  - Obstfeld and Rogoff (1983) but for exchange rates?

The global financial safety net

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- EMs need access to emergency dollar liquidity
  - During “risk off” episodes of the dollar cycle
  - Because of the occasional need to intervene in the exchange market
  - To provide dollar support to banks
- But on planet earth…
  - Such access is limited to a few…
  - That qualify for swap arrangements with the Fed
  - That qualify for IMF liquidity mechanisms
- The global financial safety net
  - Is geographically fragmented
  - Is full of holes
  - Can we do better? Yes, we can!

In conclusion....

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For emerging markets, a system of flexible exchange rates (with occasional interventions) is "the worst policy – except for all the others that have been tried"

Thank you