



Fear of appreciation [☆]

Eduardo Levy-Yeyati ^a, Federico Sturzenegger ^{a,*}, Pablo Alfredo Gluzmann ^{b,c}

^a Universidad Torcuato Di Tella, Argentina

^b CEDLAS-UNLP, Argentina

^c CONICET, Argentina

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ABSTRACT

In recent years, the term “fear of floating” has been used to describe exchange rate regimes that, while officially flexible, in practice intervene heavily to avoid sudden or large depreciations. However, the data reveals that in most cases (and increasingly so in the 2000s) intervention has been aimed at limiting appreciations rather than depreciations, often motivated by the neo-mercantilist view of a depreciated real exchange rate as protection for domestic industries. As a first step to address the broader question of whether this view delivers on its promise, we examine whether this “fear of appreciation” has a positive impact on growth performance in developing economies. We show that depreciated exchange rates indeed lead to higher growth, but that the effect, rather than through import substitution or export booms as argued by the mercantilist view, works largely through the deepening of domestic savings and capital accumulation.

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1. Introduction

In recent years, developing countries have increasingly joined the group of economies that officially run inflation targeting regimes in the context of freely floating exchange rates. While this trend has been heralded as the triumph of floating regimes, many countries are still actively pursuing active exchange rate policies. In fact, the trend seems to point this other way. In June 2003, according to the IMF, 35 countries had fully flexible regimes. By 2008 the number had dropped to just 25.¹ Additionally, even with the global financial crisis yet unresolved, international reserves in most developing countries have continued growing even when at a historical high, while some countries in recent years introduced controls on capital inflows to countervail the appreciation of their currencies. Are we re-enacting the fear of floating of the 90s, or is this a new breed of active exchange rate policy? If so, are its premises validated in the data?

To address these questions, we pursue two objectives. First, we examine the evolution of exchange rate regimes over the recent period, to identify old and new trends and, more generally, to characterize the evolution of exchange rate policy in the 2000s. It documents the prevalence of a *fear of appreciation* – namely, the tendency to intervene to depreciate (or to postpone the appreciation of) the local currency – , a fear of floating in reverse that contradicts the growing consensus built around a float cum inflation targeting (FIT) paradigm predicated on the absence of an active exchange rate policy. Second, we evaluate the implications of fear of appreciation in terms of economic performance – and, in particular, whether the neo-mercantilist rhetoric underscoring this policy delivers on its promises in terms of export growth and import substitution – for developing economies where the premise of temporary protection to domestic industries applies more naturally. We find that fear of appreciation does contribute to growth, but the channel, rather than a boost to the tradable sector, appears to lie on the effect of currency undervaluation on savings and capital accumulation.

In perspective, the exchange rate debate in developing economies in recent years revolved around the interplay of two contrasting features of financial development. First, the fact that financial globalization led to a growing ineffectiveness of monetary policy. More precisely, capital controls were found to be decreasingly effective as economies became more sophisticated, thus strengthening the restrictions imposed by the *impossible trinity* – previously circumvented due to the absence of de facto financial integration (Rose, 2007) – all of which made floating regimes more attractive. Second, the role of

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* Corresponding author. Tel.: +54 114 3298604.

E-mail addresses: fsturzen@utdt.edu, fsturzenegger@bancociudad.com.ar (F. Sturzenegger).

¹ For both dates we exclude countries from the European economic and monetary union.

(domestic and external) financial dollarization, namely, the foreign currency denomination of residents' assets and liabilities that, to the extent that it introduced currency exposures that raised the risk associated with exchange rate jumps, made pegged regimes look more attractive.² Indeed, it was the risk of balance sheet losses to financially dollarized governments and firms in the event of a devaluation – stressed in the third generation models of currency crises popularized in the context of the Asian crisis – that led to the definition of *fear of floating* (Calvo and Reinhart, 2002), namely, recurrent de facto exchange rate intervention in officially floating regimes.

The first aspect of the debate led naturally to the bipolar view (the inherent ineffectiveness and instability of conventional exchange rate bands and pegs in the presence of de facto capital mobility) that argued that financially integrated economies could either float or hard peg.³ Combined with the fear of floating view, this approach derived naturally into a “unipolar view” according to which hard pegs were the only sensible option for financially dollarized economies: if devaluations were contractionary due to balance sheet effects, exchange rate flexibility would only amplify the cycle, rather than smooth it out as predicated by the standard theory.⁴

However, while theory was going one way, policy seemed to head in the opposite direction. By the end of the decade, the success in building central bank autonomy and monetary credibility, together with the resulting decline in inflation and exchange rate pass-through, led to the growing popularity of the flexible pole of the bipolar view as the background for different varieties of inflation targeting arrangements that prioritized the inflation rate, rather than the exchange rate, as the key nominal anchor. Not surprisingly, among emerging countries, this trend started in economies with relatively low levels of financial dollarization (Chile, New Zealand, South Africa, and Brazil), gradually extending to other countries *pari passu* with a reduction in their degree of dollarization. In addition, the disappointing Argentine experience with a currency board cast doubt on the premises (monetary and fiscal discipline) on which the case for hard pegs had been predicated.⁵ Ultimately, the debate in the new millennium appears to have converged to an inverted unipolar view, whereby flexible regimes are seen as the only sensible (and durable) choice as economies grow financially integrated and sophisticated.⁶

To evaluate whether this shift towards the flexible pole is actually taking place, in this paper we update and extend Levy-Yeyati and Sturzenegger (2005) dataset (LYS) on de facto exchange rate regimes. Based on this evidence, we find that the convergence to the FIT paradigm is not taking place across the board: the share of non-floats (intermediates, conventional and hard pegs) represented 75% of the sample in 2004, exactly the same share as in 2000.

Does that mean that fear of floating has continued to be prevalent despite the favorable context and the reduced currency exposure? To get a full answer to that question, it is crucial to note a semantic nuance that has been surprisingly understated in the recent exchange rate regime literature: fear of floating, as originally defined by Calvo and Reinhart (2002), entails a clearly asymmetric exchange rate policy. Since only depreciations trigger fears of financial distress or inflation pass-through, under fear of floating the intervention response should be stronger for (if not limited to) upward exchange rate movements. More generally, the incentives and implications to intervene in order to avoid an appreciation are radically different from those related to avoiding a depreciation: where the latter focus on short-run financial crises, the former is usually predicated on long-

term economic growth. Similarly, the context conducive to one or the other differs: whereas fear of floating would tend to arise in times of financial turmoil, fear of appreciation will likely be triggered by economic bonanzas. At any rate, treating interventions in a symmetric way – in particular, attributing any intervention to fear of floating as has been previously the case in the literature – may lead to overstate the incidence of financial factors – more so in recent years when fear of appreciation appears to have prevailed.

The mercantilist view that exchange rate policy – more precisely, a temporarily undervalued currency – could be used to protect infant industries as a development strategy has a long tradition in economic theory and have recently enjoyed a minor revival. The issue of undervalued exchange rates has received considerable attention as a result of China's reluctance to float its exchange rate, a strategy presumed to be aimed at preserving the competitiveness of China's exports.⁷ In academic circles, the role of depreciated real exchange rates for stimulating growth has been discussed in Rodrik (2008) and Gluzmann et al. (2012), it has also been found important in growth accelerations (Hausman et al., 2005; Johnson et al., 2006), and has been regarded as an efficient development tool (Rodrik, 2006). More recently, the effects of overvaluation have been invoked to explain the “Dutch disease” effect of foreign aid (Rajan and Subramanian, 2011) or the disappointing growth dividends of financial integration (see Prasad et al., 2007). Despite this indicative evidence, neo-mercantilist views have been saluted, at best, with skepticism.

To assess the economic impact of fear of appreciation, we proceed in two steps. First, we refine the de facto regime classification to identify two types of foreign exchange interventions: one aimed at defending the domestic currency (as in the traditional fear of floating), and one aimed at depressing it (as in fear of appreciation). In turn, with this finer classification at hand, we assess the economic implications of fear of appreciation. Specifically, we evaluate whether foreign exchange interventions geared towards containing a process of appreciation actually help sustain a depreciated real exchange rate and, once this fact is established, we study the effect of interventions on growth. We find that fear of appreciation lead to faster output and productivity growth, which is not restricted to short-term cyclical output changes: we report a significant positive effect on the long-run component of GDP growth. However, as opposed to what it is usually argued, we find that the effect seems to come not from export-led expansions or import substitution, but rather from increased domestic savings and investment rates.

The paper is organized as follows. Section 2 introduces our extended exchange rate regime classification and reports some stylized facts on exchange rate policy in recent years. Section 3 characterizes fear of appreciation and documents its relative importance over time. Section 4 explores the economic implications of fear of appreciation, identifying links with the real exchange rate and economic growth, and examining alternatives channels that could account for the growth effect. Section 5 reviews alternative theoretical explanations for our findings, and concludes.

2. De facto regime classification: updating

In Levy Yeyati and Sturzenegger (2001), we introduced a de facto classification of exchange rates that relied on clustering country-year observations on the basis of three classifying variables: the movements of the nominal exchange rate within each year, the movements in central bank reserves (intended to capture interventions in exchange rate markets) and changes in the rate of change of the exchange rate (to capture crawling-peg regimes).⁸ The use of reserve

² See Levy-Yeyati (2006).

³ See Eichengreen (1994) and Fisher (2001).

⁴ See Frankel (2005) on balance sheet effects and contractionary devaluations, and Calvo (2000) on the unipolar view.

⁵ De la Torre et al. (2003) discusses the Argentine debacle and its implications for the exchange rate debate.

⁶ See Levy-Yeyati (2005) and references therein. Rose (2007) makes an eloquent case for the new FIT paradigm.

⁷ See Aizenman and Lee (2007).

⁸ The methodology classifies the country year data by the k-means algorithm, through a two step procedure with five groupings. See Levy Yeyati and Sturzenegger (2003a, 2003b, 2005) for further reference.

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