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Boom-and-bust cycles in emerging markets: How important is the exchange rate?★

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ABSTRACT

This paper examines the macroeconomic implications of exchange rate shocks in a sample of 13 emerging market and 6 advanced economies since the early 1990s. Factor-augmented vector autoregressions are estimated with three separate factors identified. They are: real, monetary and financial factors. The main conclusion is that there is no ‘one size fits all’ when interpreting the domestic responses to an exchange rate shock. International policies that aim to define a particular exchange rate or exchange rate regime are unlikely to be able to deal with so many idiosyncratic responses. Nor is it the case that a particular monetary policy strategy, such as inflation targeting, can immunize a domestic economy against all external shocks. International co-operation should instead encourage individual economies to seek out the menu of policies that ensure that each one's house is in order.

1. Introduction

Since the end Bretton Woods there has been considerably more flexibility in exchange rates. In emerging market economies (EME) policy makers have tended to demonstrate greater resistance to floating exchange rates (e.g., see [Reinhart and Rogoff, 2004](#); [Ilzetzki et al., 2017](#); [Frankel, 2017](#)). One cannot ignore, however, the fact that there have been large movements in nominal and real exchange rates over the past few decades.²

Broadly speaking, between 1999 and 2015, the sample considered in the econometric portion of the study, the ratio of the minimum to maximum nominal EUR/USD exchange rate is 0.56. The same ratio, over the same period, is 0.74 for China's renminbi, and 0.44 for Brazil's real, two large EME. Hence, there is considerable scope for large movements in the level of exchange rates. The last three decades have also seen sizeable fluctuations in many asset, credit and commodity prices. Indeed, when judged against the number and frequency of financial crises of various kinds (e.g., see [Reinhart and Rogoff, 2009](#); [Laeven and Valencia, 2012](#); [Bordo and Meissner, 2016](#)), there is something to be said for linking USD movements, and exchange rate movements more generally, to boom-and-bust cycles, especially in EME (e.g., [Plantin and Shin, 2016](#); [Hofmann and Schnabl, 2016](#)). However, the implications of exchange rate fluctuations are still not adequately understood (e.g., see [Forbes, 2016](#)).

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² A fairly close connection between nominal and real exchange effective rate movements exists (e.g., [Burstein and Gopinath 2014](#)). The discussion that follows will focus on nominal effective exchange rates, due to the policy implications of the proposed study.

The combination of ‘original sin’³ USD pricing of key commodities, together with the coupling and decoupling of business cycles over time, also draw attention to a relationship between USD fluctuations and economic performance in EME (inter alia, [Gopinath, 2016](#); [Ilzetzki et al., 2017](#); [Obstfeld et al., 2017](#); and references therein). Finally, ultra-low or negative interest rates may have contributed to enhancing the exchange rate channel (e.g., [Brainard, 2016](#)).

There has been comparatively little recognition given to the role of the financial cycle whose impact contrasts with the trade cycle emphasized by most authors. Under the latter a currency appreciation is contractionary since exports fall while imports rise. In contrast, the financial cycle can lead to an economic expansion since domestic balance sheets are strengthened leading to a potential rise in credit expansion.⁴

More generally, while there is a literature establishing a long-term historical link between credit or financial cycle booms-and-busts and economic activity (e.g., see [Schularick and Taylor, 2009](#)), assigning a role for exchange rates has sometimes been deemed secondary to other factors. However, this view is undergoing some changes, principally because it has become clear that financial globalization has blunted the ability of a floating regime to insulate against external shocks (e.g., [Plantin and Shin, 2016](#)). Therefore, and in spite of greater flexibility in exchange rate regimes, EME remain vulnerable to global shocks most notably from the US.

Even the shift in emphasis to focusing on the spillover effects from unconventional monetary policies (UMP) has not diminished interest in the role played by fluctuations in the USD. As Rajan, former Governor of the Reserve Bank of India, put it: “disregard for spillovers could put the global economy on a dangerous path of unconventional monetary tit for tat.” ([Rajan, 2014](#)) Beyond the real economic effects are large movements in capital flows which also react to sizeable fluctuations in the USD exchange rate. This is hardly a new phenomenon. For example, [Rodrik \(1998, p.2\)](#) points out: “Boom-and-bust cycles are hardly a side show or a minor blemish in international capital flows; they are the main story.”

Given the prospect, for example, of the continued ‘exorbitant’ privilege enjoyed by the USD (e.g., see [Prasad, 2014](#); [McKinnon, 2013](#)), it is worthwhile empirically examining how exchange rate movements impact asset, commodity markets, and economic conditions in EME more generally. Indeed, [Obstfeld and Rogoff \(2000, p. 380\)](#) argued that the “...extremely weak short-term feedback between the exchange rate and the economy” is one of the continuing puzzles of international finance. They argue that a richer model⁵ is necessary to make progress in solving this puzzle.

This paper investigates the role of exchange rate fluctuations in creating conditions that lead to drift in fundamentals potentially leading to booms-and-busts in EME. Typically, models of the kind investigated in this study focus on the impact of monetary policy shocks. Given that exchange rate shocks have different real and financial implications the present study is also interested in determining the importance of these shocks for monetary conditions and the macroeconomy more generally. The specifications considered in this paper are distinguished from others not only by the inclusion of financial factors, in addition to separate real and monetary factors, but also because US or global influences are also taken into account.

The data reveal that all EME and AE experience periods of sharp and prolonged deviations in exchange rates away from some estimated trend or equilibrium value and that the real economy and financial assets are not immune to these fluctuations. Estimates also suggest considerable cross-country diversity in the response to an exchange rate shock. Almost none of the economies investigated are immune to an exchange rate shock. Neither the chosen exchange rate regime nor the adoption of a particular monetary policy strategy (e.g., inflation targeting) is associated with a particular set of responses to such a shock. Furthermore, while exchange rate shocks can affect real, monetary, or financial factors they usually do not affect all three. Echoing [Frankel's \(1999\)](#) findings ‘one size does not fit all’ when it comes to the macroeconomic effects of exchange rate fluctuations.⁶

The rest of the paper is organized as follows. Following a review of the most relevant literature in the next section, [Section 3](#) describes the data and the methodology to investigate the main questions of interest. I provide evidence based on select individual country estimates based on factor vector autoregressions (FAVAR). Finally, in view of concerns over the reliability of VAR models with modest sample spans some local projections are also presented for selected cases. [Section 4](#) describes the main econometric results while [Section 5](#) concludes and offers some policy implications.

2. Literature review

[Rodrik \(1998\)](#) noted almost two decades ago the inevitability of large swings in financial markets, that is, of boom-and-bust cycles, adding that appropriate economic policies can reduce their likelihood but not eliminate them (also see [Bordo and Jeanne, 2002](#)).

The downplaying of the role of exchange rates began around the late 1990s and continued, until the international financial crisis of 2007–9, aided in no small part by growing evidence of a decline in pass-through effects (e.g., see [Mihaljek and Klau, 2008](#); [Jašová et al., 2016](#) for emerging markets; [Bailliu and Fujii, 2004](#), and [Choudhri and Hakura, 2015](#), for advanced economies). Since the GFC crisis, however, there has been a revival of interest in the impact of changes in exchange rates. As [Shin \(2016\)](#) notes: “Exchange rates are back in the news”. This sentiment is also echoed in a recent speech by the former vice-chair of the FOMC who notes: “[F]or small

³ This refers to borrowing in USD when restrictions and frictions that prevent or limit borrowing in the domestic currency. See [Eichengreen, et al. \(2007\)](#).

⁴ The financial channel is now also often referred to as the risk-taking channel (e.g., [Bruno and Shin 2015](#)). It is not entirely divorced from the concept of the financial cycle, an old idea revived in the aftermath of the GFC (see, [Borio 2014](#)).

⁵ That is, one that moves beyond simple purchasing power or interest rate parity relationships.

⁶ An important caveat to the role of inflation targeting is that I am unable to isolate its effects with precision both because adoption dates differ considerably across the countries in the data and the data do not readily permit separate estimation for a sample when the targets were fully in place.

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