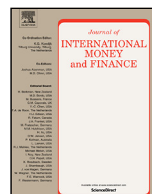
Journal of International Money and Finance 66 (2016) 65–87

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf



Exchange market pressure in OECD and emerging economies: Domestic vs. external factors and capital flows in the old and new normal

Joshua Aizenman [a], Mahir Binici [b,*]

[a] University of Southern California and NBER, University Park, Los Angeles, CA 90089-0043, USA
[b] Central Bank of Turkey, Istiklal Cad. No: 10, Ulus, Ankara 06100, Turkey

A R T I C L E I N F O

Article history:
Available online 30 December 2015

JEL Classification:
F31
F38
G01

Keywords:
Exchange market pressure
Capital flows
Capital controls
Tapering

A B S T R A C T

We study the ways domestic and external global factors (such as risk appetite, global liquidity, U.S. monetary policy, and commodity prices) affected the exchange market pressure before and after the global financial crisis, as well as the role of these factors during the Federal Reserve's tapering episode. Utilizing a comprehensive database on capital controls, we investigate whether control measures have a significant impact on mitigating exchange market pressure associated with capital flows [net and gross]. Using quarterly data over the 2000–2014 period and a dynamic panel model estimation, we find that external factors played a significant role in driving exchange market pressure for both OECD countries and emerging market countries, with a larger impact on the latter. While the effect of net capital flows on exchange market pressure is muted, short-term gross portfolio inflows and outflows comprise important factors that account for exchange market pressure. Short-term portfolio flows and long-term foreign direct investment flows have a significant impact on exchange market pressure for emerging market economies and no significant effect for OECD countries. Capital controls seem to significantly reduce the exchange market pressure, although the economic size of this impact is highly dependent on the institutional quality.

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* Corresponding author. Tel.: +90 312 507 7245.
E-mail address: mahir.binici@tcmb.gov.tr (M. Binici).

http://dx.doi.org/10.1016/j.jimonfin.2015.12.008
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1. Introduction

Over the last three decades, global financial integration has created major opportunities and challenges for policymakers in both advanced and emerging market economies. The financial integration trend, however, has faced several disruptive crises in emerging markets, including the Mexican, the Russian, and the East Asian crises in the 1990s. The last and major disruption in financial markets, the global financial crisis (GFC), originated in the U.S. and was driven by problems in the subprime mortgage market, as well as related securitization and investment activities across the globe. The highly accommodative monetary policies in advanced economies following the GFC – and more recently the policy actions and perspectives with regard to exiting from such accommodative policies – have created further challenges and instabilities particularly in emerging markets. The fact that global interest rates and asset prices have become increasingly correlated during the recent period of unconventional monetary policies has also magnified the challenges facing the worldwide financial system (Mohanty, 2014).

With increasing financial integration and resulting international spillovers, the identification and implications of channels of spillover have become important for appropriate policy designs and actions. Takats and Vela (2014), Mohanty (2014), and Caruana (2012) have distinguished and discussed five stylized spillover channels that include (i) the exchange rate, (ii) the policy interest rate, (iii) long-term interest rates, (iv) international bank lending, and (v) portfolio flows. Among these, the first and the most obvious channel of external economic conditions and domestic macroeconomic factors is the exchange rate – the focus of this paper.

The role of the exchange rate in the international spillovers depends on the exchange rate regime and related management policies. For instance, from 2010 to 2012, following the global financial crisis period, countries aiming at an export-led recovery opted to undertake devaluations/depreciations as a way to improve their competitiveness. A heated debate then ensued, dubbed the "Currency War." In the aftermath of the GFC, the weaker parts of the Euro region experienced severe debt crises that raised concerns regarding the sustainability and stability of the Eurozone. The growing asymmetry between the expansionary policies of the FED and the deflationary trends in the Eurozone, as well as the growing financial instability of Euro's periphery, have magnified the euro/dollar exchange rate volatility and contributed to the large euro depreciation during 2014–2015Q1.

Given the large fluctuations of key exchange rates and their importance as an international-spillover channel, understanding the role of domestic and external factors, international capital flows, and capital controls in determining the exchange market pressure has been understudied in recent years. This paper aims to fill this gap, analyzing the degree to which domestic factors and external global factors (risk appetite, global liquidity, U.S. monetary policy, commodity prices, and the like) have affected exchange market pressure before and after the GFC. Utilizing a recent comprehensive database on capital controls, we also explore whether net and gross capital flows and capital control measures have a significant impact on exchange market pressure. In addition, this research complements the studies on the transmission of U.S. tapering talk during 2013 to emerging market economics (Aizenman et al., 2014; Eichengreen and Gupta, 2014) by focusing on the exchange market pressure before and after the GFC.

Large fluctuations of the exchange rate are an important issue in policy considerations for countries concerned with the sustainability of external imbalances as well as for export-oriented economies. Exchange rate fluctuations may have a substantial effect on financial stability via numerous macro channels, including destabilizing balance sheet effects. Indeed, currency substitution and currency mismatches at the aggregate level have been linked with banking and debt crises in emerging markets (e.g., Chile in the 1980s and Mexico in the 1990s; BIS, 2008). Capital flow composition has become more important for exchange rate fluctuations as short-term flows are more prone to sudden reversals (Ahmed and Zlate, 2014, and the references therein). During the GFC, unconventional monetary policies put forth by advanced economies' central banks led to large flows of capital into emerging economies and encouraged carry trade activities. The recent wave of capital outflows from emerging markets has been mainly in the form of portfolio investments – which includes equity and debt flows – as the uncertain international economic outlook has also impacted the flow of foreign direct investment (FDI) to emerging market economies (EME). Figs. 1 and 2 show the total net capital flows as well as gross inflows and outflows of a sub-group of the OECD and emerging market countries.

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