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What explains global exchange rate movements during the financial crisis?

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A B S T R A C T

A striking and unexpected feature of the financial crisis has been the sharp appreciation of the US dollar against virtually all currencies globally. The paper finds that negative US-specific macroeconomic shocks during the crisis have triggered a significant strengthening of the US dollar, rather than a weakening. Macroeconomic fundamentals and financial exposure of individual countries are found to have played a key role in the transmission process of US shocks: in particular countries with low FX reserves, weak current account positions and high direct financial exposure vis-à-vis the United States have experienced substantially larger currency depreciations during the crisis overall, and to US shocks in particular.

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1. Introduction

The current financial crisis has caused sharp movements in global exchange rate configurations. Before the crisis, there was a fairly widespread consensus that the large global imbalances in current account positions and underlying capital flows to finance these imbalances would ultimately require a large depreciation of the US dollar. The argument was that a decline in the value of the US dollar is inevitable to achieve an improvement in US competitiveness and thus a sustainable reduction in the US trade deficit (e.g. Obstfeld and Rogoff, 2005; Blanchard et al., 2005). A widespread fear was that such an adjustment may occur suddenly and be rather disruptive (Krugman, 2007).[1]

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[1] Of course there are also dissenting voices, arguing that the large US current account deficit is the result of a natural outcome of financial globalization in general and a preference for US financial assets in particular (e.g. Caballero et al., 2008; Cooper, 2008).

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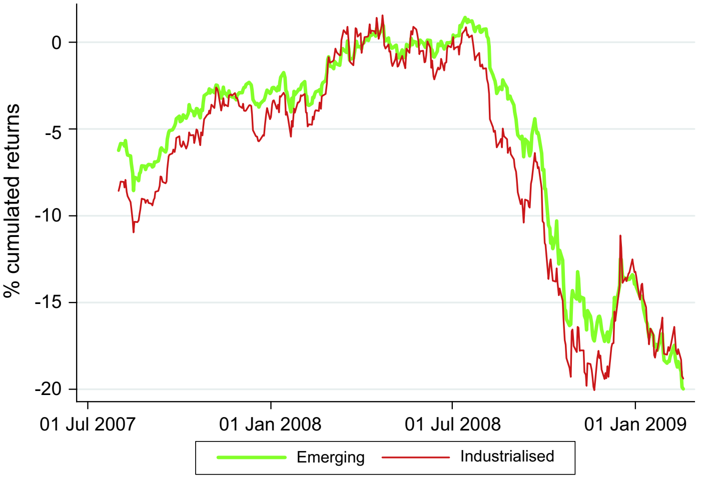

Fig. 1. Bilateral USD exchange rate movements during the financial crisis – industrialized versus emerging market economies.

In short, there was a fairly widespread expectation that a US dollar depreciation would play an important if not central role in the global adjustment process. However, as we now know, the adjustment process has taken a very different path with a collapse in asset prices and a massive deleveraging process among financial institutions being at the core of the crisis. Moreover, one of the striking characteristics of the crisis, in particular since its intensification in the summer of 2008, has been a very substantial appreciation, rather than depreciation, of the US dollar against virtually all but a few currencies. This is even more striking given that the United States was the origin of the financial crisis, and that at least many emerging markets had initially little direct financial exposure by holding relatively few US toxic assets.

Fig. 1 illustrates this pattern in global FX configurations, showing that while the US dollar depreciated somewhat in 2007 and the first half of 2008 (an upward movement in the figure), it appreciated sharply from July 2008 onwards (a downward movement), and in particular in the weeks following the collapse of Lehman Brothers in September 2008. While Fig. 1 indicates that this appreciation trend of the US dollar has been present equally against exchange rates of advanced economies and emerging markets, Fig. 2 shows that nevertheless the heterogeneity in bilateral exchange rate movements against the US dollar has increased significantly after July 2008, implying that countries have fared very differently with regard to exchange rate movements.[2]

What explains these sharp and unexpected movements in global exchange rate configurations? And why has there been so much heterogeneity across countries in currency developments during the crisis? There are at least three factors that are being stressed as having played a seminal role for global FX movements in 2008 and 2009. The first one relates to a sharp reversal in the pattern of global capital flows, in particular since the summer of 2008 as US investors started withdrawing capital from abroad to raise cash for redemptions, or a more general flight-to-safety phenomenon in which both US and foreign investors have shifted out of equities and into fixed income instruments, particularly into (presumably) safe US government bonds and bills. A second prominent factor is the need for US dollar liquidity of non-US firms, which helps explain the loss in FX reserves among several, in particular emerging market central banks, and the establishment of a significant number of swap arrangements of the Federal Reserve with central banks in both advanced and emerging economies. And third, the unwinding of carry trade positions appears to have been a prominent factor for some currencies, in particular such as the sharp rise of the Japanese yen since the summer of 2008.

[2] The figures exclude de facto fixed exchange rate regimes; a more detailed discussion follows below in Sections 2 and 3.

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