

Exchange rate puzzles and dilemmas: how can policymakers respond?

Remarks on the Policy Panel

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We have had two days of intense, fruitful and profound discussions. The experiences of a number of countries have been analysed, and some of the most important policy issues faced by central bankers have been highlighted. During my keynote address, I discussed some exchange rate-related issues that I believe are of importance for central bankers. Among these, perhaps the most current one relates to what central bankers in small open economies should do in the light of aggressive policy actions by the Federal Reserve and/or the European Central Bank. Should central banks in small open economies such as Thailand or Colombia follow the Fed, or should they pursue fully independent policies, based on their own policy rules?

Instead of repeating myself, what I would like to do during these closing remarks is to emphasise what I believe are the most important lessons from our discussions, and at the same time highlight where I believe we have left some loose ends. In addition, I would like to address three specific issues that, surprisingly, have been mostly absent in our deliberations.

Of course, the most important conclusion from our discussions during the last two days is that the exchange rate matters for monetary policy. Indeed, the exchange rate *matters a lot*, and in more than one way. This does not necessarily mean that the exchange rate should enter the policy rule as an additional term in the Taylor Rule. What it *does mean*, however, is that countries whose central bankers pay insufficient attention to currency developments are likely to experience heightened macroeconomic volatility.²

However, taking the exchange rate into account when implementing monetary policy is no easy task; it is easier said than done. A significant problem is that, in spite of major research efforts over the four decades since the abandonment of the Bretton Woods system, we still face a number of exchange rate-related puzzles. One such puzzle that has been discussed extensively at this conference is the “exchange rate disconnect,” or the fact that exchange rate behaviour is not easily explained by the models that the economics profession has developed. This point was made in the 1980s by researchers such as Dick Meese and Ken Rogoff, Rudy Dornbusch and others. The truth of the matter is that, in the intervening 30 years, we have only improved our models marginally; the “disconnect” is still with us. I should notice, in parenthesis, that in the mid-1980s a number of researchers – including myself – addressed this problem by arguing that exchange rate changes were almost always the consequence of “news” and, thus, unpredictable by definition. Although this

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² It should be noted that I am arguing that the exchange rate should be taken into account beyond its obvious effect on domestic inflation via the price of tradable goods.

perspective is technically solid, it is not useful for practical men and women, or for the anxious central banker.

Another important lesson that emerges from our discussions is the fact that the nominal exchange rate is not neutral in the short run. Indeed, large nominal exchange rate changes will elicit in the short run – a run that can last up to nine months, if not longer – significant real effects that will impact economic activity, including unemployment. The issue, of course, has to do with the size of the “pass-through coefficient,” and with the relationship between nominal exchange rate changes and real exchange rate changes at different time horizons. This topic was researched extensively by Michael Mussa during the 1980s; his conclusion was that real exchange rate changes were overwhelmingly dominated by nominal exchange rate fluctuations. This is still true today.

As I pointed out during my keynote speech, the recent (2015–17) experience in Mexico is a clear example of the problem at hand: for political reasons – the so-called “Trump effect” – the Mexican peso depreciated at a very fast pace starting in mid-2015. In fact, the peso lost value much faster than what was justified by fundamentals. These developments introduced significant hardship into the Mexican economy, and made the job of Mexico’s central bank governor, Agustín Carstens, extremely challenging. The policy rate was lifted by 425 basis points in a 20-month period!

Another important policy question raised at the conference – a point emphasised, in particular, by Charles Engel – is the extent to which capital controls should be part of the policy kit used by central bankers. Again, this is an old question. Perhaps not as old as the discussions on the “exchange rate disconnect puzzle,” but dating, at least, back to the late 1980s. In a number of quarters it has become fashionable to argue that although controls on capital *outflows* do not work effectively and result in significant costs, small open economies should consider using controls on *inflows* as a way of avoiding excessive exchange rate volatility and speculation. As with many issues related to the connection between currencies and monetary policy, the empirical evidence is not 100% clear. While some researchers claim to have found that controls on inflows reduce exchange rate volatility, others have failed to unearth a significant and persistent effect.³ Part of the problem with evaluating the effectiveness of capital controls on inflows – which often take the form of unremunerated reserve requirements, or URRs – is that they have usually been implemented at the same time as an active exchange rate intervention policy is enacted. This was indeed the case in Chile during the 1990s; what makes Chile’s experience particularly important is that this was the first country to systematically adopt a URRs policy. After the controls on inflows were enacted in 1990, exchange rate volatility declined noticeably. However, the question remained of whether reduced currency volatility was the result of the controls on inflows, or a consequence of the policy of currency intervention, which at the time took the form of an exchange rate band. In order to address this issue, Roberto Rigobón and I developed a model where we calculated the “shadow” exchange rate, or currency value that would have prevailed in the absence of the bands. We concluded that the lower volatility was mostly the result of the band, and not of the controls on inflows. At the same time, we found that the unremunerated reserve requirements on short-term inflows did

³ Much of this research has been undertaken for the case of Chile, a pioneer in the use of controls on inflows.

change the maturity of capital inflows; short-term flows were reduced, while longer term ones – including FDI – increased.⁴

Let me now turn to three topics which, surprisingly, were not addressed during our deliberations.⁵ The first one is “sudden stops,” a phenomenon studied in great detail by Guillermo Calvo, myself and others. Many small open economies that run relatively large and persistent current account deficits are, from time to time, subject to a sudden and very massive reduction of capital inflows. This phenomenon has been quite common in Latin America; it was widespread in Asia during the East Asian crisis in 1997–98, and more recently affected Iceland (2008). When capital inflows suddenly dry up, and countries are forced to adjust, the costs in terms of unemployment and reduced economic activity can be very significant. The key question here is how central banks should prepare themselves for the eventuality of a sudden stop episode. Indeed, incorporating this type of scenario into the analysis provides an additional rationale for an active international reserves accumulation policy on behalf of the monetary authorities. Of course, the question of the efficiency of “self-insurance” programmes is still on the table, and should be discussed and analysed in greater detail.

A second issue which was not discussed during our deliberations has to do with “current account reversals”. Although this phenomenon is closely related to “sudden stops,” it is not exactly the same. There is abundant evidence suggesting that there have been a number of historical episodes of sudden stops which have not been accompanied by current account reversals.⁶ The explanation is that in a number of instances countries have been able to use international reserves, or official capital from the multilaterals, to cushion the effects of a sudden change in private capital flows.

The “reversals” issue is intimately connected to the question of whether there are certain thresholds for current account deficits beyond which the economic authorities should become concerned. This problem is related to what is sometimes referred to as the “Lawson Doctrine”.⁷ In the early 1980s, Nigel Lawson, the Chancellor of the United Kingdom’s Exchequer, argued that there was no reason to be concerned about very large current account deficits, if the imbalances were the result of private sector decisions. In his view, to the extent that massive deficits – we are talking here of current account deficits in excess of 5% or 6% of GDP – were financed with private monies, there was no cause for concern. However, the empirical evidence emanating from a number of exhaustive research projects indicate that independently of the sources of financing, very large current account disequilibria are likely to be followed by very significant adjustment processes which are costly to the economy. This is particularly the case when the adjustment is accompanied by a very large devaluation – a relatively recent example of this is the Argentine peso crisis of 2001–02. In that regard, and from the perspective of the topic of this conference, a pertinent question

⁴ S Edwards and R Rigobón, “Capital controls on inflows, exchange rate volatility and external vulnerability”, *Journal of International Economics*, vol 78, no 2, 2009, pp 256–67.

⁵ Another important topic that was absent from our discussions has to do with the “shadow” banking sector.

⁶ S Edwards, “Thirty years of current account imbalances, current account reversals and sudden stops”, Mundell-Fleming Lecture, *IMF Staff Papers*, 2004.

⁷ O Blanchard, “Current account deficits in rich countries”, *IMF Staff Papers*, vol 54, no 2, pp 191–19, 2007.

is how central bankers should react to very large external imbalances. One possibility, which was followed by the United States towards the end of the 20th century, is benign neglect. At that time, the US current account deficit moved towards 6% of GDP, a situation that led a number of economists to predict that the dollar needed to depreciate in real terms by around 15% in order for equilibrium to be re-established. And yet, the US authorities – both at the Treasury and the Federal Reserve – were rather blasé. But of course, the United States is in a unique position, having the “exorbitant privilege” of being able to “print” international reserves. A question for future gatherings of this group, then, is how central bankers in small open economies, including most Asian and Latin American nations, should face large and persistent current account imbalances.

The final topic which, in my opinion, needs to be addressed in discussions that connect monetary policy with exchange rates has to do with “fear of floating.” This topic, which has been researched extensively by Guillermo Calvo and Carmen Reinhart, is of importance in many – if not most – small open economies.⁸ The question is whether the economic authorities are willing to allow the currency to find its own equilibrium, independently of how large the depreciation happens to be. In the fear-of-floating literature, there are a number of reasons – currency mismatches in the banking sector, being the most important one – for the authorities, including the central bank, to be concerned about the consequences of a free-floating regime. In particular, if the corporate sector has large foreign currency-denominated debt, a major depreciation will tend to create significant financial havoc. In terms of our conference deliberations, the question is how central banks should behave in a world of currency mismatches and financial vulnerabilities. The most accepted answer is that macroprudential regulations should be put in place, in order to avoid financial distress stemming from an open capital account and a floating exchange rate. The next step in this discussion, then, is the exact nature of these macroprudential regulations. But that of course is the topic for a new conference.

⁸ G Calvo and C Reinhart, “Fear of floating”, *Quarterly Journal of Economics*, vol 117, no 2, 2002, pp 379-408.