Currency hierarchy and challenges for economic policy in emerging economies

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Main argument and hypothesis

- ✓ Starting point: Keynesian literature (i.e. Arestis/Sawyer 1998; 2006)
  - ✓ Monetary stability is insufficient to assure a sustainable growth path
  - ✓ Relevance of counter-cyclical and macro-prudential policies
  - ✓ Coordination of macroeconomic policy (monetary, exchange rate, fiscal, labour and sectorial policies etc.)
- ✓ How applicable are Keynesian policies to emerging economies?
- ✓ Hypothesis: international monetary asymmetry related to currency hierarchy imposes major constraints to monetary and exchange rate policies in emerging markets.

3. Currency hierarchy

- ✓ International monetary system as hierarchical and asymmetric institutional arrangement organized around a hegemonic currency, with a privileged position in the monetary hierarchy.
- ✓ Investors concentrate portfolios in key currencies (US dollar, Euro, Yen, etc.)

- ✓ "Currency Hierarchy" (i.e, Cohen 1998; 2004)
  - ✓ Below the key-currency (US dollar), currencies issued by other advanced ("northern") countries
  - ✓ At the bottom, currencies issued by developing ("southern") countries

2. Liquidity premium and currencies

✓ In a monetary economy, different assets, including money, have specific attributes:

- the expected appreciation, *a*
- the expected quasi-rent, *q* ;
- the carrying cost, *c;*
- the liquidity premium, *l* (non-pecuniary return linked to uncertainty)
- The combination of these attributes yields an *asset's specific interest rate* ($\boldsymbol{r_a}$) (or its total expected return):

$$r_a = a + q - c + l \quad (1)$$

✓ Assets denominated in different currencies

→ equation (1) can be applied

✓ Yet, pricing of currency assets is peculiar:

- ✓ Variable *a as* exchange rate determined by expectations, not fundamentals
- ✓ Variable *q* as interest rate
- ✓ Variable *c* as degree of financial openness

3. Currency hierarchy

✓ Foreign exchange markets at equilibrium (by arbitrage):

$$\mathbf{a_n + q_n - c_n + l_n = a_s + q_s - c_s + l_s} \qquad \textbf{(2)}$$

✓ Currency hierarchy: $l_s < l_n$

✓ To be compensated by $(a_s + q_s - c_s) > (a_n + q_n - c_n)$

4. Limits of economic policy in EM:
a. Monetary policy

- ✓ Currency hierarchy requires compensation of the difference between the liquidity premium of currencies (north and south)
- ✓ Interest rate differential ($q_s > q_n$) should compensate lower liquidity premium ($l_s < l_n$)

- ✓ Traditional transmission channels of monetary policy are constrained by:
  - ✓ lower financial development that makes monetary policy less sensitive to wealth effect.
  - ✓ low credit-to-GDP ratio makes credit channel less effective.
  - ✓ as a result, less effective transmission channels requires *higher domestic interest rates.*
- ✓ Higher exchange rate pass-through in EM compared to developed countries (in low/middle income countries consumption basket have predominance of tradable goods) results in *higher levels of inflation*.

5. Limits of economic policy in EM: b. exchange rate policy

- ✓ Procyclical capital flows are determined mainly by exogenous forces → exposure EM to boom bust-cycles
- ✓ *Boom phase*: EM currencies becomes "objects of desire" of global investors as $q_s > q_n$
  → tendency of currency appreciation: *a* increases
  → built-up of risks in the capital account (greater external vulnerability) and in the financial sector (credit boom, asset bubble)
- ✓ *Bust phase*: EM currencies are first sold due to differences in the liquidity premium ($l_s < l_n$) and increasing expectation of currency depreciation (reduction of *a*)
  → pressure to raise interest rate (increasing *q*) and to deepen financial openness (reducing *c)*
  → when successful, ($a + q - c$) will continue compensating $l_s < l_n$, but *GDP growth will drop down!*
  → when not successful, *currency crisis and sudden stop of capitals!*
  - ✓ $r_a = a + q - c + l$

6. Limits of economic policy in EM: b. exchange rate policy

- ✓ *International asymmetric integration* (volume of capital flows x small size of financial market): higher volatility of *a* (exchange rate):
- ✓ '*fear of floating'* behaviour (Calvo/Reinhart 2002) due to possible effects of currency depreciation on external liabilities and domestic inflation.

-> short-term interest rates are used to smooth the exchange rate movements.

- ✓ EM in an asymmetrical monetary system face the problem of *greater loss of exchange rate and monetary policy autonomy.*
- ✓ Dilemma not a trilemma of economic policy (Rey, 2013): floating exchange rates cannot insulate economies from the global financial cycle, when capital is mobile.

7. Economic policies for EM

- ✓ Relevance of reducing the volatility of exchange rate (*a*)
  - ✓ reduces pressure on *q* (domestic interest rate)
  - ✓ may at the medium / long-term increases liquidity premium (*l*) as exchange rate risk decreases
- ✓ *Relevance of trade surplus and balanced current account*: can decrease the country's dependence of foreign capital and consequent need of high interest rates.
- ✓ EM economies should avoid commitment with very low inflation levels.
- ✓ Broader goals of economic policy require a broader set of tools (Tinbergen's theorem): the need of policy coordination (exchange rate, monetary, fiscal, income policies, etc.).

7. Economic policies for EM

- ✓ Which tools have peripheral emerging economies available to reach these objectives and to increase policy space?
  - ✓ “Self-insurance” strategy of foreign reserves accumulation
  - ✓ Capital account regulation (capital controls and domestic prudential measures)
  - ✓ Both can contribute to increase policy space
  - ✓ Managed floating exchange regime that allows to combine some flexibility with a competitive exchange rate
  - ✓ Development of domestic financial market to reduce country’s external vulnerability (reduction of currency mismatches) and also to enhance traditional transmission mechanisms of monetary policy

Concluding remarks

- ✓ Post Keynesian policies formulated to pursue the goal of full employment should be adjusted for the case of emerging economies under the conditions of an asymmetric global monetary order.

- ✓ High relevance of exchange rate objective
  - ✓ different policy mix and coordination of economic policies
  - ✓ higher emphasis on stable and competitive exchange rate
  - ✓ other instruments as reserve accumulation and capital account regulation

- ✓ If this policy set is rather ambitious, holds even more for policy prescriptions to climb up the currency hierarchy.

- ✓ However, not all countries can climb up at the ladder of the hierarchy at the same time.

Thank you