UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNITED NATIONS

CENTER FOR
INTERNATIONAL
DEVELOPMENT
HARVARD UNIVERSITY

G-24 Discussion Paper Series

Can Flexible Exchange Rates Still "Work" in Financially Open Economies?

Ilan Goldfajn and Gino Olivares

No. 8, January 2001

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

CENTER FOR INTERNATIONAL DEVELOPMENT HARVARD UNIVERSITY

G-24 Discussion Paper Series

Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs

UNITED NATIONS

New York and Geneva, January 2001

Note

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

*

*   *

The views expressed in this Series are those of the authors and do not necessarily reflect the views of the UNCTAD secretariat. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

*

*   *

Material in this publication may be freely quoted; acknowledgement, however, is requested (including reference to the document number). It would be appreciated if a copy of the publication containing the quotation were sent to the Editorial Assistant, Macroeconomic and Development Policies Branch, Division on Globalization and Development Strategies, UNCTAD, Palais des Nations, CH-1211 Geneva 10.

UNCTAD/GDS/MDPB/G24/8

UNITED NATIONS PUBLICATION

PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

CAN FLEXIBLE EXCHANGE RATES STILL "WORK" IN FINANCIALLY OPEN ECONOMIES?

Ilan Goldfajn and Gino Olivares

Department of Economics, PUC-Rio,
Rio de Janeiro, Brazil

G-24 Discussion Paper No. 8

January 2001

Abstract

Recent studies have shown that exchange rates in developing countries have limited flexibility. In this paper we review the existing explanations for this stylized fact, using a simple framework of monetary policy in a world where firms face balance sheet effects and the economy has a high pass-through from depreciation to inflation. We estimate a panel regression using quarterly data in the period 1990–1999 for a sample of 46 countries (19 industrial and 27 developing), and find that the use of the exchange rate to buffer external shocks depends crucially on (i) on the degree of integration with capital markets, and (ii) the quality of external financing. We conclude that flexible regimes are viable in financially open economies, provided external financing is not based on very volatile capital. This, of course, is dependent on the establishment of credible macroeconomic policies.

Table of contents

CAN FLEXIBLE EXCHANGE RATES STILL "WORK" IN FINANCIALLY OPEN ECONOMIES?[*]

Ilan Goldfajn and Gino Olivares

I. Introduction

The recent failure of several emerging economies to sustain managed currencies has led, in general, to the support of extreme regimes, either hard pegs, such as currency boards or even full dollarization, or pure floating regimes. There is a rich debate on the relative advantages and costs of hard pegs, pure floating or intermediate regimes in the economic literature (Calvo, 2000; Chang and Velasco, 2000; Eichengreen and Hausmann, 1999; Mishkin, 1999; Rodrik, 2000; Velasco, 2000; Williamson, 1998).

In this paper we take a different angle on the choice of exchange regimes. We concentrate on the effect of high capital mobility on the usefulness of different exchange rate regimes, in particular on the render currency depreciation an ineffective – at worst harmful – policy option?

We analyse these issues, observing the data and the relevant stylized facts. First, we document the degree of volatility of the exchange rate in floating regime economies. Second, we examine the sensitivity of interest rates to foreign interest rate shocks. Third, we report on the contractionary effects of devaluation in emerging economies. Finally, we briefly analyse two case studies in Latin America, Mexico and Brazil, and comment on the recent performance of these floating exchange economies.

The stylized facts seem to indicate that developing countries prefer to allow a higher volatility of reserves and interest rates in exchange for a lower volatility on their exchange rates, at least as compared with industrial economies. Second, the