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**Macroeconomic Shocks and Exchange Rate Regimes:
A Comparison of Selected Emerging-Market and Industrial Countries**

Shaghil Ahmed, Christopher J. Gust and Steven B. Kamin*

Division of International Finance, Board of Governors of the Federal Reserve System
Washington, DC 20551

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Abstract

As a result of emerging-market crises of the past few years, a consensus appears to be building that fixed, but adjustable, peg regimes are inappropriate for these countries and that these countries should be encouraged to move to some form of “polar” exchange rate regimes. However, it is far more settled which polar regime, fully flexible rates or firmly pegged rates—such as through a currency-board or outright dollarization—is preferable. One of the factors that taints the textbook case for floating rates, and keeps this controversy alive, is the considerable evidence, especially for Latin America, indicating that devaluations are contractionary (in that they depress output) in these countries. This suggests that exchange rate adjustments may not work in these countries according to the predictions of traditional economic theory.

However, this criticism has often been countered with the following arguments: (A) Most developing countries have not really had much experience with pure floating exchange rate regimes. Rather, their experiences have been characterized by a mixture of a series of failed (adjustable) pegs and brief periods of floating rates. (B) When the pegs have adjusted, it has often been in crisis situations in which some shocks are driving both the collapse of the exchange rate as well the recession, making it look like devaluations are contractionary.

In this paper, we argue that one possible way to resolve these issues, and shed some light on the current debate about the choice of exchange rate regimes in developing countries, is to compare the experience of three different types of economies to various macroeconomic shocks: (1) key Latin American countries (Argentina, Brazil, and Mexico in our sample) which appear to have especially strong contractionary effects of exchange rate depreciations; (2) selected industrial countries that have floated their currencies for a long time now, and the majority of which are commodity exporters (Australia, Canada, New Zealand, and Switzerland in our sample); and (3) selected industrial countries that, like the Latin American countries, have switched back and forth between fixed and floating exchange rates and also experienced pressure on their currencies from time to time (Finland, Italy, Sweden, and the United Kingdom in our sample). This would delineate whether it is something about the type of exchange rate regimes

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that have historically been followed or something inherently different about Latin American countries that explains their perverse (from the viewpoint of traditional economic theory) output response to exchange rate changes. Moreover, in looking at the effects of exchange rate shocks in each of these group of countries we keep fixed the effects of key external shocks that can be taken to be given to these small open economies, viz, terms of trade shocks, world real interest rate shocks, and output shocks in their major trading partners.

Our preliminary results, which are obtained by estimating a dynamic panel vector autoregression (VAR) for each of the three groups of countries are very striking: There is some evidence in all these countries supporting the textbook predictions that adverse external shocks cause a real depreciation of the currency, although in some cases the effects are weak. However, the effects of exchange rate shocks, in turn, differ in interesting ways between two of the groups. In the Latin countries, even keeping fixed the effects of the three exogenously given external shocks mentioned above, exchange rate shocks (measured as depreciations) are contractionary. In sharp contrast, unanticipated depreciations of the currency affect output positively in the industrial floating countries. Most interestingly, the response of output to exchange rate shocks for the industrial countries that have had a history of Latin-American style exchange rate regime changes displays exactly the pattern seen in industrial floating-rate countries, rather than the one seen in the Latin countries.

These findings strongly suggest that: (1) the result that exchange rate real depreciations are contractionary in the Latin American countries is robust to keeping fixed some of the candidates for possible other shocks that may simultaneously affect exchange rates and outputs; and (2) this result appears to be a consequence of something inherently different about Latin American countries (e.g. most of their long-term borrowing being in foreign currency) rather than because of the wavering exchange rate policies they have followed historically.

Key words: Exchange rate regimes, dollarization, Latin America, economic fluctuations, devaluations.

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Authors' E-mail Addresses:

Ahmed = shaghil.ahmed@frb.gov

Gust = christopher.gust@frb.gov

Kamin = steven.kamin@frb.gov