Comments on papers by Gagnon and Thorstensen et al.

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I. Motivation, Scope, and Main Message

- The role of FX intervention in influencing the current account and relative prices is a controversial and yet key policy issue.

- Both papers make an important contribution to this debate.

- My discussion will focus on technical aspects of their analyses re. problems of measurement and of econometric identification.

- Will do so by drawing on broad historical trends and without delving into any particular country cases.

- Main bottom-line: measurement as well as normative inferences on effects of intervention are tricky, calling for caution on sweeping inferences.
II. Facts and Questions

- **Key Stylized Fact**
  
  Conspicuous Long-Run Association between Reserve Accumulation by EMs and Global CA Imbalances.

- **3 Key Questions**
  
  Is this historically abnormal?
  Can we infer causality and clearly single out the role of policy?
  Do intervention policies enhance welfare, even if only national?
Fact I: post-1970 Trends

- Long upward trend in Global Reserve Accumulation [began in the early 1990s, but really picked up after the 1997-98 EM crises].

- General Trend: Not just due to China or Asia.

- Associated with widening in NFA positions between creditors and debtors.
Fact I: post-1970 Trends

Global Official Reserve Holdings (as share of World GDP)
Fact I: post-1970 Trends

Distribution of Net Foreign Assets/GDP Between Debtors and Creditors

- Net Debtors
- Net Creditors

1970: -60%
1980: -40%
1990: -20%
2000: 0%
2010: 60%
Fact II: Historical Parallels

- Similar trends also observed in past.

- Close Parallel: the 1890s financial crises

- Faced with massive recovery of capital inflows in the 1900s, many countries pegged their currencies to gold → reserve accumulation soared!

- Post-crisis CAs improve, never returning to higher pre-crisis deficits.

- Pegging to gold never dubbed “currency manipulation”.
Fact II: Historical Parallels

Pre-WWI Parallels: Reserve Accumulation and CA in Emerging Markets

- 1890s Financial Crises and Global Recession
- Current Account improves as private capital flows in and Reserves go up

Chart showing reserve accumulation and current account (CA) in emerging markets, highlighting periods of financial crises and global recession.
III. Causality: Econometric Issues

- At the root of Joe’s hypothesis is imperfect substitutability between official and private foreign assets/liabilities.

- Quite plausible (much in the way that full Ricardian equivalence is implausible).

- But how far policy can exploit it to engineer large (and long-lasting) relative price shifts is difficult to test.
III. Causality: Econometric Issues

- Endogeneity and spurious cor. is a serious issue given accounting identity: $CA = FA + \Delta FX_{res} + E&O$.

- So, regressing $CA = X'\alpha + \beta \Delta FX_{res}$ will yield a biased coefficient $\beta$.

- If CAs are mainly driven by financial account shocks, $\beta$ is biased downward.

- If trade shocks dominate, $\beta$ is biased upwards.
III. Causality: Econometric Issues

- On annual regressions and without instrumenting, Bayoumi and Saborowski (2012) find $\beta \sim 0.5$ and significant despite the possible bias towards zero.

- But only if $\Delta F\!X_{\text{res}}$ is interacted with $K_{\text{controls}}$.

- Joe instruments it and finds instead that $\beta \sim [0.6, 1.0]$ with regressions on 5-year averaged data.

- But also that $\Delta F\!X_{\text{res}} \times K_{\text{controls}}$ is non-significant!
Ill. Causality: Econometric Issues

- Many potential issues with both results.

- One is sensitivity to instrumenting

- Another is accuracy of Kcontrol indices (de jure instead of de facto indices, and they sometimes disagree)

- No distinction made between the effects of FXres accumulation via sterilized vs. non-sterilized intervention.

- Nor between exchange rate regimes (pegs or near pegs vs. managed floating)

- Use of 5-year averaged data more likely to bias $\beta$ upward
My recent work uses instruments that distinguishes between sterilized vs. non-sterilized intervention.

- Finds a coefficient of $\Delta FXres*Kcontrols \approx 0.6$ and a much smaller (and imprecisely estimated) $\beta$ on the non-interacted term.

- But also find that the $\Delta FXres$ terms in CA regressions are the ones that are the least robust to specification searches!

- And results may not be robust to dropping a few countries from the sample (dropping just a few can notably weaken the results)

- **Bottom line:** Caution to infer too much from estimates!

- More work will be needed to satisfy all doubts
Is misalignment so tempting? Can policies aimed at a weaker exchange rate boost a country’s welfare?

One view is that tradables production -- manufacturing in particular—generates greater economies of scale and learning by doing, so play a special role in development.

Difficult to test, prove/disprove.

Incentive to depreciate at odds with some standard welfare analysis:
IV. FX intervention, Misalignment, Tarification, and Welfare

- A policy of *appreciating* the ER in order to improve the country’s terms of trade may appear attractive (“TOT externality”)

- Incentive stronger for the manufacturing exporter facing a downward sloping world demand curve – the standard *optimal tariff argument*.

- Holding the currency down has obvious costs.

- One is to make production inputs dear, so reducing effective protection. Tarification measures of currency policies need to incorporate that!

- **Fact**: RER appreciation is typically associated with higher I/Y!
IV. FX intervention, MisalignmentTarification, and Welfare

- Capital market imperfections (e.g. risk of Sudden Stops) may justify FXres accumulation geared at mitigating appreciation.

- Indeed, Catão and Milesi-Ferretti (2013) find that higher reserves/GDP do reduce the risk of major external crises. And this is beyond the effect of higher NFA/gdp and higher CA balances.

- But if so, how much FX is enough, how much is too much?

  - Fiscal cost of massive sterilization (esp. at near zero world interest rates) is important for high return/high growth EMs.
  - Another cost may be the ToT loss
IV. FX intervention, Misalignment Tarification, and Welfare

- Holding currencies down with the aid of K controls may have benefits (Ghosh et al. 2008), but not problem-free.

- First, it may be ineffective, particularly in EMs with sophisticated capital markets (Chamon and Garcia, 2013).

- Second, when is done with a more comprehensive set of controls, it can generate distortions that lower TFP (Hsieh and Klenow, 2009), and so is welfare-reducing.

- Third, political economy effects can be perverse → long-lasting growth and welfare losses (Diaz-Alejandro, 1970; Taylor, 1998).
Both papers are important contributions to the debate on FX intervention and CA imbalances.

From a positive perspective, measurement of effects of intervention is trickier than it may seem, calling for caution on sweeping inferences.

Price-based misalignments are difficult to measure with reasonable accuracy and to sustain into the long-run just on the basis of one-side sterilized intervention without other instruments.

From a standard welfare perspective, the net benefit for undertaking such policies is often unclear, even from a purely national/Nash perspective.