Currency Appreciations Come in Different Shapes and Sizes

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Exchange rate policies that are at the center of policy discussions are introducing new challenges for Latin America. While China is resisting a nominal appreciation, countries like Brazil, Chile and Uruguay have already experienced significant nominal and real appreciations of their currencies. Others, namely Argentina, are suffering a strengthening of their currencies as domestic inflation far exceeds the rate of nominal depreciation.

This trend is causing concern as these real appreciations affect the ability of the countries' industrial and service sectors to export and grow, which in some cases is associated with the so-called "Dutch disease."

The currency war discussions and the adoption of policy measures to avoid sharp and rapid real appreciations of the currencies do not clearly distinguish the different forces that could underlie these processes. There are at least three different factors that are important and the policy response should in principle differ depending on the relative importance of each of them: differences in growth and productivity rates, improvements in terms of trade and capital inflows.

The higher rates of growth in emerging markets are part of the explanation. There is ample theoretical and empirical evidence that countries which grow faster experience real appreciations. This movement, however, should be gradual and, in general, the adjustment in relative prices transpires with a stable exchange rate and through increases in domestic prices. The countries that adopted the euro are examples of cases in which the real appreciation took place through inflation.

The second factor—the improvement in the terms of trade—could have larger and more sudden impacts on the real appreciation of the currency, especially if there are large increases in export prices, affecting the current account of the balance of payments. Many Latin American countries are commodity exporters and now face these new policy challenges while the terms of trade gains generate windfalls, representing in some cases 60 percent of GDP from 2004-2008.

If the terms of trade effects are large and not permanent, a real appreciation should be unavoidable in the long term. Policymakers could delay this process by intervening in the foreign exchange market to avoid a rapid nominal appreciation of the currency, and then sterilize the monetary effects of these purchases by issuing domestic debt to avoid an increase in domestic demand and inflation.

However, sterilized foreign exchange intervention is not enough to prevent "Dutch disease," as it leads to large increases in domestic debt and eventually to higher domestic interest rates that could generate capital inflows and complicate overall macroeconomic management.

The alternative and most effective policy response to the large terms of trade windfalls, which many countries in Latin American have been enjoying during the last decade, is to rely primarily on fiscal policy. This could happen through increases in public sector savings to compensate for the increase in domestic aggregate demand, or by the creation of a stabilization fund, like the ones that Chile or Norway have been using to sterilize the higher export proceeds from copper or oil. In the case of Norway, it has accumulated funds that are larger than its nominal GDP.

In Latin America, most countries did not use fiscal policy or failed to introduce stabilization funds to counteract the improvements in the terms of trade that took place during the decade. Calculations indicate that in the region there was a tendency to spend rather than to save the fiscal windfall— a policy that favored the real appreciations of the currencies. In most countries, increases in spending were close to, or exceeded, the increases in revenues during the recent boom. For instance, Brazil spent more than 3 percent of the GDP of the windfall in tax revenues.

In Argentina, the government increased export taxes during the boom, mainly on soybean products. These new taxes raised as much as 10 percent of overall government revenues and were equivalent to 3 percent of GDP. However, these revenues were spent rather than saved and hence did not work as a countercyclical policy to avoid further pressures on the currency.

One result of the failure to use countercyclical fiscal policy was the increased effect of the higher revenue felt on domestic aggregate demand, eventually leading to an increase in the price of non-tradeable goods. As a result, even when countries did not allow the nominal exchange rate to appreciate, they faced a strengthening of their currencies in real terms.

Finally, capital inflows are the third and most important factor that has been pressuring the Latin American currencies toward appreciation. This factor also created the largest challenges for macroeconomic policies as they tend to be big relative to the size of the trade flows and they can fluctuate very quickly.

Some of these inflows have been "pulled" by improvements in macroeconomic policies and by the better growth prospects than those of the industrialized countries. Most of these flows were in the form of foreign direct investment and long-term lending, which by and large are perceived as "good" capital inflows since they improve the growth prospects and are not perceived to increase financial vulnerability.

The main headache has been created by the short-term capital inflows that to some extent are being "pushed" by the very low interest rates that prevail in the industrialized countries, and that come to take advantage of the "carry trade" opportunities that the short-term interest rate differentials create. These flows, as experience shows, are likely to be very volatile and could leave as quickly as they came in, leading to large and disruptive fluctuations in the exchange rate.

A reversal of these flows is likely to take place if and when U.S. interest rates rise from the current extremely low levels, which is likely to happen in the next couple of years, and that could lead to the phenomenon that Guillermo Calvo et al have termed the "sudden stops".

While most economists and policymakers agree that it makes sense to try to limit the fluctuations in the exchange rate, the policy response is not always clear or effective. For instance, the efforts to avoid a nominal appreciation through sterilized intervention in the foreign exchange market could lead to a vicious cycle as they could lead to higher domestic interest rates, which in turn would lead to more capital inflows.

The alternative is to limit the short-term flows through regulation or the imposition of capital controls. There has not been any shortage of imagination in this field, as countries have tried everything on the menu. Unfortunately, all these policies work for a few months at best, but over time they lose their effectiveness as the financial markets find ways to elude them. Countries face great difficulties in closing all the loopholes without severely affecting trade flows and investment.

When countries put controls on short-term flows, investors find that the "financial time machine" can transform 90-day credits into two- or three-year loans. When there are limits on financial loans, all of sudden the country is flooded with commercial loans. The introduction of a tax on capital inflows can at best have short-term effects, as is the case with dual exchange rate systems that have a fixed exchange rate for commercial transactions and a flexible rate for financial ones.

There are different types of currency wars. This instance with China is the traditional beggar-thy-neighbor "trade" war, in which countries are concerned about trade surpluses and deficits. In Latin America, the problem is, to some extent, related to large windfalls in terms of trade. But recently, it has been mainly driven by short-term capital inflows that have proved to be very volatile and will likely revert very quickly in response to a rise in U.S. interest rates. It makes sense to try to smooth them, but it won't be easy.