THE BROOKINGS PODCAST ON ECONOMIC ACTIVITY

"Will a strong dollar hurt emerging markets?"

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Episode Summary:

A strong U.S. dollar reflects economic and political strength for the United States. But a new study published in the Brookings Papers on Economic Activity illustrates how a strong dollar might not be good for other countries, especially emerging and developing markets. On this episode of the Brookings Podcast on Economic Activity, Brookings Senior Fellow Gian Maria Milesi-Ferretti interviews the authors of that study, Maurice Obstfeld of UC Berkeley and Haonan Zhou of Princeton University. Obstfeld and Zhou explain what's driving the stronger dollar, why it might hurt emerging markets, and policies those emerging markets can use to become more resilient to dollar appreciation shocks.

[music]

EBERLY: I'm Jan Eberly, James R. and Helen D. Russell Professor of Finance at Northwestern University.

STOCK: And I'm Jim Stock, Harold Hitchings Burbank Professor of Political Economy at Harvard.

EBERLY: We're the coeditors of the *Brookings Papers on Economic Activity*, a semiannual academic conference and journal that pairs rigorous research with real time policy analysis to address the most urgent economic challenges of the day. This is the Brookings Podcast on Economic Activity.

In this episode, we're presenting a conversation between Gian Maria Milesi-Ferretti, senior fellow with the Hutchins Center on Fiscal and Monetary Policy at Brookings, Maury Obstfeld, The Class of 1958 Professor of Economics at the University of California, Berkeley, and Haonan Zhou, Ph.D. student at Princeton University. Maury and Haonan are authors of a new paper on the global dollar cycle.

STOCK: For a number of reasons, the dollar is strong today. For example, both the euro and the pound are trading nearly one for one with the dollar at the moment. While a strong dollar makes many imports cheaper for U.S. consumers, it can cause problems abroad, especially in emerging market economies.

EBERLY: This paper emphasizes the importance of financial asset flows rather than trade in goods between countries. Those emerging markets are better able to export goods to the U.S. when the dollar is strong, but their own weaker currencies make debt payments more expensive and create other challenges. A currency depreciation is a much more mixed blessing than we used to think.

STOCK: For more, let's listen to Gian Maria's conversation with Maury and Haonan.

MILESI-FERRETTI: Good afternoon. I am Gian Maria Milesi-Ferretti. I'm a senior fellow at the Hutchins Center for Fiscal and Monetary Policy at the Brookings Institution. And I am very happy to welcome you to this Brookings Podcast on Economic Activity. We have two special guests: we have Maury Obstfeld, professor of economics at Berkeley, former chief economist at the IMF, my thesis advisor and old friend. I'm very happy to see him. And Haonan Zhou, who is a Ph.D. candidate at Princeton University. Welcome to this podcast.

OBSTFELD: Thank you, Gian Maria.

ZHOU: Thank you, Gian Maria, for having us here.

MILESI-FERRETTI: And we have Maury and Haonan here to discuss a fascinating new piece of research. It's a paper called "The Global Dollar Cycle," and maybe we can dive right in. So, to start, I think one fascinating angle here is that, from the U.S., we often hear that a strong dollar is good for America. It reflects confidence in its economic and political strength. So, the question arises, is this good for other countries? And should in principle a strong U.S. economy be good for the world economy? Maybe, Maury, I can ask you this question.

OBSTFELD: Sure, Gian Maria. I'm happy to take that on. The effects of exchange rates are always complicated, so think about the strong dollar. On the one hand, it makes it cheaper for American tourists to go to Europe or elsewhere. On the other hand, it makes it harder for U.S. exporters to sell their goods abroad. So, it's always a kind of a double-edged sword.

For emerging markets and actually for the world more broadly—but particularly for emerging markets—there is a pattern, which we document in the paper, of dollar strength being associated with weaker growth and also with weaker performance to the number of global aggregate activity indicators that are critical for emerging market growth and welfare.

This really goes back to at least the 1980s, if you think about the Volcker disinflation and the fiscal measures that the U.S. undertook in the Reagan administration. These drove the dollar to great heights, but also were associated with a sharp slowdown globally and a debt crisis in developing countries that led to a decade of lost growth.

What we see in the data and we document in the paper in a number of ways is this negative correlation between dollar strength and growth. And we can see it with emerging market growth rates, but we also see it in the fact that a stronger dollar means slower growth of world trade, which is critical to the welfare of emerging markets. We see it in the fact that a stronger dollar means lower commodity prices, a pattern which is somewhat muddied at the moment by the disruptions associated with the war in Ukraine but does hold over the longer term.

MILESI-FERRETTI: Thank you, Maury. So, if I may follow up on what you just said and ask Haonan what do your findings say about the factors that drive dollar strength? Why does the dollar increase in value relative to other currencies? And are those factors something that can help us understand better the unfavorable consequences of dollar strength for emerging and developing economies?

ZHOU: Thanks, Gian Maria. So, broadly speaking, we can classify the factors affecting the strength of the dollar into two separate camps. So, the first set of factors include both the short term and the long-term interest rate differentials between the U.S. and other major advanced economies. So, they typically reflect the role of monetary policies, both in the sense of traditional interest rate policies, as well as unconventional policies like QE, as well as something on the fiscal side, for instance, the debt management policies of the U.S. So, we typically find that the dollar tends to appreciate during periods of relatively higher U.S. short term interest rates.

So, we also establish a strong connection between relative tightening of U.S. long-term rates and a stronger dollar, primarily driven by expectations of future short-term interest rates. So, for near-term movements of the dollar, it looks like this relationship becomes stronger in recent years when the QE policies were in place.

Another important source of dollar exchange rate fluctuations comes from the financial markets. So, as the dollar's safety and liquidity are particularly valued by global investors, when there is a declining risk appetites of global investors, investors will exhibit flight to safe assets, and this appreciates the dollar.

So, in our analysis, a direct measure of credit market sentiments, which is called the access bond premium, turns out to be one of the most reliable and influential correlates of dollar movements. So, the assets bond premium captures the difficulty of U.S. corporates facing raising funding on the market, which is not directly attributable to firms' individual default risk. So, it's a measure of credit market sentiments, and it has been shown to be a powerful predictor of both U.S. recessions and EM [emerging market] sovereign risk.

So, we show that as the premium rises, which means that the U.S. market becomes more stressful, the dollar would actually appreciate. So, an important part of the movements in the dollar exchange rate can be explained by shifts in global risk sentiments.

So, to answer your second question, it turns out that this kind of financial tightening could actually have a particularly large and persistent negative effect on emerging markets because adverse financial conditions could propagate to emerging markets, with one important channel being movements in dollar exchange rates and the results are rising government borrowing costs and falling equity prices. And on the real side of the economy, slower growth for the EMEs [emerging market economies].

So, I just want to add that, historically, U.S. monetary policy tightening are bad news for EMEs [emerging market economies] because it generates capital outflow pressures and shrinkage of global demand. Our analysis indicates that one important additional dimension of consideration is financial markets fluctuations arising out of the U.S.

OBSTFELD: And Gian Maria, if I could just jump in here. Haonan has described the links between financial tightening globally and the dollar. The fact that whenever there's a global tightening, there's a flight to safety, a rise in global risk aversion. This tends to be associated with dollar strengthening and that directly affects emerging markets.

But it's kind of a double whammy for them because emerging markets tend to have large shares of their external liabilities, sometimes internal liabilities, particularly debt liabilities that are denominated in dollars. And so, when the dollar strengthens the value of those liabilities in terms of the domestic economy rises, and that makes it harder for firms, households, even governments to borrow in those economies.

So, for many reasons, a dollar tightening is kind of a perfect storm. It's driven by these tight global financial conditions. But then the emerging markets, because of their financial structures, are particularly vulnerable to what dollar tightening does to balance sheets in those countries.

MILESI-FERRETTI: Maybe to make all these points very directly to our listeners as they relate to specific episodes, can you give us just a couple of examples of periods of rising global risk aversion that have seen this type of pattern with emerging markets spreads widening, dollar appreciating, and so on in the past 15 years, 20 years or so?

OBSTFELD: Well, we saw one particularly dramatic episode in the early spring of 2020 with the emergence of COVID and lockdowns across the world. The dollar spiked up sharply. Capital flows to emerging markets reversed sharply, and the world economy contracted sharply, including the emerging markets. In this particular case, we were fortunate that advanced economies, particularly the United States, entered the fray with very expansionary monetary policies; the Fed also set up a special repurchase facility for Treasuries, because the Treasury market came under stress and extended swap lines to some emerging markets whereby the Fed would lend dollars to their central banks so their central banks could use those dollars to lend to their corporates and financial institutions. And those very strong measures helped to stabilize the situation.

That playbook followed what had happened after the Lehman collapse, which is another very salient episode of a spike in global risk aversion and a spike in the dollar, where again, the Fed used to swap line tools and a suite of new quantitative operations in order to stabilize financial markets.

Perhaps the opposite situation of more global risk appetite and a depreciating dollar and a flip to growth in emerging markets came during the Fed's quantitative easing, the later quantitative easing episodes following the Lehman event, where the dollar reached one of its lowest points in its post 1973 history. There were large capital flows to emerging markets. Emerging markets, in fact, were at full employment, didn't want to grow faster and have more inflationary pressures. And this led the finance minister of Brazil to complain that the U.S. was engaging in a currency war by weakening the dollar in order to spur its own exports.

So, this cuts both ways, but these episodes occur periodically, which is why we think of a dollar cycle of medium-term frequency. Right now, we seem to be in an upturn in the dollar cycle where the dollar is appreciating having depreciated after the spike in the spring of 2020.

MILESI-FERRETTI: Thank you, Maury, this is fascinating, and it really brings the results of the paper into the real context of the main shocks we have seen in the world economy over the past couple of decades, really.

So, I wanted to follow up on one intriguing parallel that you make in the paper, and that is the parallel between the global macro situation now and the one that prevailed almost 50 years ago as the Bretton Woods system of fixed exchange rates was collapsing. The world back then was rocked by energy price shocks, inflation was rising, two developments clearly bring to mind what is happening now. Could you elaborate maybe on this comparison and outline for our listeners what you see as the main policy lessons we've learned in regard to this previous episode?

OBSTFELD: It's a fascinating comparison. It struck us as we were writing the paper that by the time the paper is published in the *Brookings Papers*, we'll be pretty much at the March 2023 fiftieth anniversary of the month in which effectively the advanced economies gave up on the fixed exchange rate system that had been founded at Bretton Woods in the 1944 conference.

And it also struck us how superficially similar the circumstances are to then, and unusually so given the experience of the last few decades. As you mentioned, 1973 was a year marked by severe commodity price shocks, not just for energy, the OPEC shock, but also for food. It was marked by high inflation in the United States, but also spilling over into other economies and wage pressures around the world. So, just go back and look at the issues of the *Brookings Papers* from that period. *Brookings Papers* started in 1970, so it was still a young publication. But there are some very famous papers, like Bill Nordhaus on the worldwide wage explosion, Bob Gordon's work on international aspects of global inflation.

So, after the Volcker period, the conquest of inflation, inflation targeting, the great moderation, suddenly we find ourselves again in a situation where inflation rates are high across the world, interest rates are being raised everywhere in advanced and emerging market economies to get those inflation rates under control. Commodity prices, already high due to reopening from COVID, have been pushed up further due to the Ukraine war. They may be coming down a little now, but they still remain historically high.

And moreover, if we go back to 1973, remember it was the collapse of a system centered on U.S. leadership. And it came in a period when there was a lot of geopolitical tension over the Vietnam War and the U.S. role in that, a period in which U.S. leadership of the world economy had come into question because the U.S. took several unilateral actions to bolster its balance of payments position in the early 1970s. It forced the devaluation of the dollar. It abrogated its gold commitments to U.S. reserve holders under the Bretton Woods system.

So, all in all, a situation of great turbulence with questions about how would the world economy evolve in this new system. What would happen to U.S. leadership? What were the geopolitical implications? One important geopolitical implication was the drive for Europe to draw closer together and to contemplate a single currency actually began in that period.

So, now we find ourselves in a similarly disorienting phase where following the four years of the Trump administration, there's a serious debate within the U.S. about global leadership. There's a serious concern among U.S. allies about whether that will continue in the way it has been. There's a severe geopolitical conflict regarding Ukraine in the first place, but also increasing tensions with China. And there's a real risk of fragmentation of the world economy into different blocs, perhaps a Chinese-Russian-Belorussian-Serbian bloc. We don't know what it will look like. The Western and to some extent some Pacific Rim, richer economies. And then the emerging world in between trying to navigate that.

So, the current macroeconomic situation is eerily familiar and challenges the certainties we had when we talked about the great moderation to the extent that those survived the financial crisis. And it also challenges the trend of global integration that reached its high point in the first decade of this millennium. So, a lot of food for thought behind the more narrow question of how the dollar affects emerging markets.

MILESI-FERRETTI: This is really a fascinating view of how complex the international picture is and how many similarities going beyond the couple of economic ones I had highlighted.

Staying on the theme of the receiving end of these shocks and these cycles, I wanted to ask, Haonan, what can emerging markets in developing countries actually do to protect themselves from these financial market shocks that really originate outside their borders?

ZHOU: So, I think the first message is that emerging markets in developing economies aren't completely helpless to these shocks originating outside of their own country. On the other hand, just to briefly summarize our key finding from our analysis, we found that the adverse impact of dollar shocks could be more pronounced for countries that are more rigid in terms of their arrangement. Countries that peg their exchange rate or manage their exchange rate heavily could suffer relatively more from these dollar appreciation shocks.

On the other hand, also, we noticed that countries with an inflation targeting framework tends to perform relatively better than countries that do not have an inflation targeting framework. And it's, Maury already mentioned, countries that have high levels of external liabilities denominated in the U.S. dollar could see their balance sheet relatively revalued to the downside when dollar appreciates against their own currencies. These countries we also show that they relatively perform worse in the face of a dollar appreciation shock.

So, the positive lesson is quite simple in this case. It follows that flexible exchange rate regimes could actually be very useful in buffering these external financial shocks. But it can achieve its benefit maximumly when it's supported by measures such as increasing the inflation credibilities of central banks and also effectively reducing their level of external liabilities denominated in U.S. dollars.

MILESI-FERRETTI: Thank you, Haonan. And maybe if I could just have a short follow up before we close. The situation we see currently, the degree of stress across emerging markets seems to differ. And we seem to have a category of emerging markets that may be a bit more sophisticated on the policy front that looks more resilient. But a large number of others that instead that look very vulnerable to this battery of shocks, including the dollar strength that are currently buffeting the world economy. Do you have any thoughts on this?

OBSTFELD: Well, let me offer some thoughts on that. As a result of the COVID pandemic, debt burdens of emerging markets went up everywhere. Lost revenues, fiscal support, medical expenditures—all of those factors were important. And countries were able to borrow externally in part because of the very expansionary monetary policies of the Fed and low global interest rates, low risk premia. All of that is coming into question now.

And generally many emerging markets reacted quite expertly to the crisis in terms of their adopting of a range of monetary policies that looked a lot more like what advanced economies do and had been the case in the past, if you look at the toolkits they developed. But they're also reacting to higher inflation now. So, in addition to having higher debt burdens, inflation has kicked in.

And as Haonan mentioned, one of the important developments of the last decades in a number of emerging markets was to develop sounder monetary frameworks, often to target inflation. They brought inflation down from much higher levels a couple of decades ago. And they're concerned, I think rightly concerned, with preserving that credibility, because it does provide a valuable buffer against external shocks.

So, we see and we document this in the paper not only advanced economies raising interest rates this year, but emerging economies raising rates, in fact, having started earlier than most advanced economies even last year, and continuing to raise rates. Ghana, which is one of the countries threatened with debt distress, raised interest rates by 300 basis points. Hungary has raised interest rates massively, South Africa recently. So, just across the board, we see this. And this, of course, increases government debt burdens, as do the higher dollar borrowing costs that these countries are now facing.

The larger emerging market countries which have proactively raised interest rates—I mean, I think of Brazil, which has raised them a lot—don't seem seriously in peril at this point, but a number of smaller countries do. You look at Sri Lanka. Think of the Tunisias, the Lebanons, Egypt. These countries are quite vulnerable to entering some sort of renewed debt distress. There are a couple that are classed by themselves. Look at Turkey, it's running 80% year-on-year inflation. They lowered their interest rate by 100 basis points. The government is somehow trying to hold the economy together until the June 2023 election, and I just don't see how that's going to end well. So, again, you know, as Tolstoy said, each unhappy family is unhappy in its own way. But there's certainly severe threats out there.

MILESI-FERRETTI: Well, thank you very much, Maury, and thank you very much, Haonan. This was an absolutely fascinating discussion, and I hope our listeners are going to pick up your paper as soon as it becomes available. It's really a fascinating read. Thank you very, very much for this. All the best.

OBSTFELD: Thank you, Gian Maria.

ZHOU: Thank you, Gian Maria.

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STOCK: I'm Jim Stock, Harold Hitchings Burbank Professor of Political Economy at Harvard University.

EBERLY: And I'm Jan Eberly, James R. and Helen D. Russell Professor of Finance at Northwestern University. We're the co-editors of the *Brookings Papers on Economic Activity*, and this has been the Brookings Podcast on Economic Activity. Thanks to our colleagues for this great conversation, and be sure to subscribe to hear more discussions with BPEA authors.

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