Boom-and-Bust Cycles in Emerging Markets: How Important is the Exchange Rate?

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Summary

The last three decades have seen sizeable fluctuations in exchange rates, many asset prices, and credit and commodity prices. Indeed, when judged against the number and frequency of financial crises of various kinds there is something to be said for linking USD movements, and exchange rate movements more generally, to boom-and-bust cycles, especially in Emerging Market Economies (EME).

This paper investigates the role of exchange rate fluctuations in creating conditions that lead to a drift in fundamentals potentially leading to booms-and-busts in EME. We estimate a series of vector autoregressions using quarterly data for a group of 19 economies around the globe to determine how they respond to various exchange rate shocks. Given that exchange rate shocks have different real and financial implications the study is also interested in

determining the importance of these shocks for monetary conditions and the macroeconomy more generally.

The data reveal that all EME and Advanced Economies (AE) experience periods of sharp and prolonged deviations in exchange rates away from some estimated trend or equilibrium value, and that the real economy and financial assets are not immune to these fluctuations. Estimates from econometric models suggest considerable cross-country diversity in the response to an exchange rate shock. Equally important, almost none of the economies are immune to an exchange rate shock, to the chosen exchange rate regime or even the adoption of a particular monetary policy strategy (e.g., inflation targeting). Both the stylized and the econometric evidence in this study support Jeffrey Frankel's conclusion reached almost twenty years ago, in spite of the global financial crisis. Therefore, 'one size fits' all does not apply to how different economies react to exchange rate shocks.