Macroeconomic impact series

Currencies pressured amid Brexit

Currency policy matters for development

Phyllis Papadavid

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Key messages

- With a prolonged period of risk aversion likely to continue, sharp currency moves in developing and emerging economies could persist.
- For some developing and emerging economies, a dual currency system could be an appropriate means to temporarily absorb multiple macroeconomic shocks.
- Although vastly different, China and Ethiopia's past experiences offer insight on how currency policy can be used to mobilise growth.

Greater currency volatility

One week ago, roughly $2 trillion was lost in global equity markets, following the UK's vote to leave the EU. In response, several developing country central banks, including the Reserve Bank of India and the Bank of Korea[1] intervened to stabilise their currencies. With a prolonged period of risk aversion ahead, sharp currency moves in developing and emerging economies could continue. For some of these economies, a dual currency system could be an appropriate means to absorb such external shocks.

There is no precedent for Brexit. However, there are some things we know. The cost of sharp currency moves is potentially high, as currency falls tend to hurt incomes. Take Argentina. It has had repeated devaluations, or official changes, in the peso. Some have been astonishing: 387% in April 1989 and 220% in February 1990. With 40% inflation, a third of Argentina's population still cannot afford a basic basket of weekly groceries.[2]

Even before Brexit, many emerging and developing country currencies were already near or at record lows following multiple shocks: lower oil and commodity prices faced by resource exporters, a strong US dollar, rising US interest rates and a slowing Chinese economy. Now, heightened geopolitical risk is an additional challenge. It is likely that continued risk aversion would redirect investment away from developing countries perceived as risky.

A balanced currency policy

Many countries' economic woes, including Argentina's, do not stem from their currency, or their multiple exchange rate regimes. Countries that have been successful have used multiple currencies, particularly for commercial transactions, as a temporary shock absorbing measure.[3] Unsuccessful policies have relied too much on either fixing the value of their currency to another (instituting a peg), as a quick solution to stabilise inflation, or on devaluation (officially mandated changes in the currency) to stimulate exports.

Exchange rate pegs sometimes work, but they are often unsustainable. In an open economy, with mobile capital flows, monetary policy needs to be fully committed to maintaining the peg's value.[4] This is why pegs are accompanied by capital controls, to reduce the risk of a currency crisis. Pegs usually prove problematic because, if a currency is deemed overvalued, central banks have only limited reserves to counter market selling. Overvalued currencies also make exports unprofitable. As export earnings decline, foreign exchange becomes scarce and governments resort to foreign exchange controls, as Nigeria and others have done. This reduces remittances to the banking system and handicaps private sector activity.

Currency devaluation alone is also problematic. In most of sub-Saharan Africa, declines in nominal exchange rates have not had an effect on broader real exchange rate competitiveness. This is, in part, the result of rigid domestic prices. Additionally, in some cases such as South Africa, the uncertainty around the future course of policy has also been found to limit exporters' responsiveness to the exchange rate.

China and Ethiopia's experience

China and Ethiopia have vastly different economies. And yet, both have achieved exceptional growth in gross domestic product per capita over the past decade. A key link has been public investment in infrastructure. Since 2000, average public investment was 22% and 18% of GDP respectively, compared with sub-Saharan Africa's 7%.[5] Their dual currency systems may have also supported their growth accelerations: they facilitated the purchase of capital goods, leading to more productive factors of production, and stimulated exports.[6]

From 1979 to 1995, China's dual currency system[7] cheapened its capital goods imports and its exports.[8] From 1995, a managed floating regime saw its currency, the renminbi, rise by over 50% in inflation-adjusted, trade-weighted terms and a tripling of China's global trade share. In Ethiopia, since the late 1980s, an overvalued birr was used to import capital goods for large-scale infrastructure for greater agricultural productivity.[9] The 1991 birr devaluation (of 59%) came with key complementary reforms including the elimination of export duties and a dual currency system.

China and Ethiopia's exchange rates are still volatile. Ethiopia still operates capital controls and periodically devalues the birr. January's renminbi devaluation was so destabilising that China's authorities temporarily suspended trading in the domestic stock market. Notwithstanding this, both countries' historic experience offers some examples of how currency policy can be used to mobilise growth. Given the risk ahead for sharp currency moves, a dual currency system could be an option for some economies to safeguard their growth.

Endnotes

1. http://in.reuters.com/article/emerging-cenbank-intervention-idINKCN0ZA38J
2. http://www.cavallo.com.ar/wp-content/uploads/argentina%20miracle.pdf
3. http://www.nber.org/chapters/c7672.pdf
4. http://www.worldbank.org/afr/wps/wp16.pdf
5. https://www.imf.org/external/pubs/ft/scr/2014/cr14304.pdf
6. A strong currency can also be sustained by high capital inflows (such as in the US).
7. https://www.imf.org/external/np/seminars/eng/2013/macro2/pdf/gy.pdf
8. http://www.brookings.edu/~/media/projects/bpea/fall-2008/2008b_bpea_rodrik.pdf
9. http://www.ipe-berlin.org/fileadmin/downloads/Papers_and_Presentations/IPE_WP_70.pdf

Overseas Development Institute
203 Blackfriars Road
London SE1 8NJ
Tel +44 (0)20 7922 0300
Fax +44 (0)20 7922 0399

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