Analysis of an unannounced foreign exchange regime change

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ARTICLE INFO

Article history:
Received 23 April 2011
Received in revised form 6 June 2011
Accepted 8 June 2011
Available online 30 November 2011

JEL classification:
F31
F40
F41

Keywords:
Exchange rate
Foreign exchange market
Market power

ABSTRACT

Starting in 2004 the Guyanese foreign exchange rate has been remarkably stable relative to earlier periods. This paper explores the reasons for the stability of the rate. First, the degree of concentration in the foreign exchange market has increased, thus making the task of moral suasion relatively straightforward once this policy tool comes to bear on the dominant trader(s). Second, long-term or non-volatile capital inflows make the exchange rate less susceptible to sudden reversal. Third, commercial banks, the dominant foreign exchange traders, have large outlays of assets in domestic currency, thus their desire for exchange rate stability. The econometric exercise is consistent with the notion that trader market power has contributed to lower volatility in the G$/US exchange rate. The paper also presents a model that analyzes monetary policy effects in the presence of a mark-up or threshold interest rate.

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1. Introduction

As part of a broad macroeconomic reform agenda implemented in 1988, Guyana adopted a floating exchange rate in 1990 (Egoume-Bossogo et al., 2003; Thomas and Rampersaud, 1991). The parallel or street rate was merged with the official rate as one aspect of comprehensive macroeconomic and financial sector reforms. A notable spread, prior to 1990, existed between the official and parallel rates; however, as the reforms intensified the spread declined and the rates converged (Fardmanesh and Douglas, 2008). The agenda of foreign exchange market reform was not limited to Guyana.
Instead, it was a widespread reform movement in other parts of the world such as the Caribbean and African economies (Fardmanesh and Douglas, 2008; Galbis, 1993). The banking and financial sector reforms pursued in Guyana included: promoting financial market development, decontrolling interest rate, implementing market-based monetary policy through a Treasury bill auctioning framework, privatizing state-owned banks, and dismantling direct credit schemes (Das and Ganga, 1997; Egoume-Bossogo et al., 2003).

Starting from around 2004, despite the extensive nature of the financial reforms, the exchange rate moved from a relatively flexible to a virtually fixed rate.¹ This regime shift went unnoticed to most except the IMF which started to classify Guyana as having a de facto pegged exchange rate regime (IMF, 2006). Heretofore, the academic literature has not analyzed this silent transition; thus this paper intends to make a contribution in that regard. However, using a probit model, Hagen and Zhou (2005) examine the factors allowing for a divergence between de facto and official exchange rate regimes in twenty-five Transition economies. They argue that it is less costly to adjust the de facto exchange rate because less commitment is required.

Upon examination of the institutional features of the foreign exchange market, the paper argues that this market is highly concentrated where a few commercial banks dominate the trading of foreign currencies. Therefore, we postulate that trader market power and high concentration (in the foreign exchange market) helps in the stabilization of the rate. In addition, given that commercial banks, in the aggregate, possess a large portfolio of assets in domestic currency (loans, Treasury bills and excess reserves), it is not in their interest to see the nominal exchange rate depreciate rapidly because of the potential inflation pass-through. Therefore, to the extent that moral suasion is used as a monetary management tool, it is more likely to succeed given the institutional features of the Guyanese foreign exchange market.²

Moreover, the paper also hypothesizes that the nature of capital inflows facilitates and buttresses the market power role of the commercial banks in stabilizing the rate.³ Portfolio or hot money inflows are very small relative to stable long-term capital inflows. The latter include foreign direct investments, remittances, aid funds, and multinational loans. Remittances form an important source of foreign exchange inflows; therefore, to the extent the altruistic motive to remit is dominant, this form of foreign exchange inflow eases the exchange rate volatility and reinforces the strategic exchange rate formation role of the large commercial bank traders.⁴

The paper adopts a three-tier methodology to present its case. Firstly, we present a narrative approach outlining stylized facts and features of the Guyana foreign exchange market. Secondly, we present a simple model that illustrates how a threshold domestic interest rate influences the central bank’s management of commercial bank reserves (as is done under the financial programming model). The threshold is identified by an aggregate commercial bank liquidity preference curve that becomes flat at the interest threshold, which is assumed to be a mark-up over the foreign interest rate. Thirdly, we provide some econometric evidence which models exchange rate volatility and concentration as measured by the Herfindahl–Hirschman index.

The paper is structured as follows. Section 2 presents background information that outlines the de facto pegged rate and other key macroeconomic variables. Section 3 examines the composition of capital inflows. Section 4 explores the structure and features of the foreign exchange market. Section 5 presents several arguments why the rate stabilized. Section 6 presents a theoretical model which shows that a binding threshold mark-up interest rate could generate a stable exchange rate in the presence of monetary expansion. Section 7 provides econometric evidence that shows that exchange

¹ The issue of exchange rate stability is important because volatility tend to be inversely related to economic growth (Schnabl, 2008).
² It should be noted that the central bank has never announced that moral suasion is part of its monetary policy toolkit. Instead, the central bank indicates that it follows an indirect monetary policy tool that manages commercial bank excess reserves. However, Egoume-Bossogo et al. (2003) suggest that moral suasion was exercised during 1996–1997 when there was major political unrest.
³ Sudden swings in capital inflows – especially short-term inflows – can be devastating and result in bankruptcies, destruction of the credit channel, and impose an adverse effect on human capital (Calvo, 1998).
⁴ Agarwal and Horowitz (2002) found the altruistic motive to be the important factor in determining the inflow of remittances into Guyana.
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