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Monetary policy options for mitigating the impact of the global financial crisis on emerging market economies

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ABSTRACT

Though the hypothesis that exchange rate regimes fully predetermine monetary policy in the face of external shocks hardly finds any advocates in the field of theory, it has crept into empirical research. This study adopts a careful and rigorous empirical approach that looks at monetary policy options used in order to accommodate the global financial crisis. We examine the GDP growth in 41 emerging market economies in the most intense phase of the crisis and confirm that there is no clear difference in the growth performance between countries at the opposite poles of the exchange rate regime spectrum. Moreover, we find that the monetary policy option of depreciation *cum* international reserves depletion outperforms other options, especially the rise in the interest rate spread. We also discover certain complementarities between information on policy option and on exchange rate regime. We use quantile regression, which provides a more complete picture of the relationships between the covariates and the distribution of the GDP growth.

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1. Introduction

One of the most important arguments against a fixed exchange rate regime is the necessity of making the stabilization of an exchange rate a primary objective of monetary policy. By doing this, monetary authorities lose autonomy in the sense that monetary policy cannot be used in order to stabilize the output or employment (domestic objectives) unless capital flows are controlled. The reasoning is rooted in the so-called trilemma or the impossible macroeconomic trinity: one cannot have the exchange rate stability, unfettered capital flows and monetary policy oriented toward domestic objectives at the same time.[1] The opponents of a flexible exchange rate argue that such an arrangement contributes to uncertainty, which has an adverse effect on international trade and welfare.[2]

Frenkel (1999) aptly points out that, even in the face of a gradual process of international financial integration, the trilemma does not mean that a country has to choose between the exchange rate stability and monetary autonomy: "there is nothing in the existing theory, for example, that prevents a country from pursuing a managed float under which half of every fluctuation in the demand for its currency is accommodated by intervention and half is reflected in the exchange rate" (Frenkel, 1999). Taking his idea a step further, one can argue that thanks to an additional monetary policy instrument, i.e. foreign market intervention, it is possible to ease the conflict between domestic and external objectives. In other words, even if there are no barriers to capital flows, the exchange rate regime *per se* does not fully predetermine the stability of output and exchange rate.

The global financial crisis has entailed large economic and social costs but at the same time it has provided a unique opportunity (in a sense of a natural experiment) to investigate the effectiveness of monetary policy options adopted by emerging market economies to accommodate adverse external shocks. These economies have differed not only in the relative crisis resilience, but also in the policy option chosen to neutralize the impact of the crisis.[3]

The objective of this paper is to identify policy options used by monetary authorities in emerging market countries and to investigate their role in making the global financial crisis milder for their economies. The existing studies devoted to the role of monetary factors in shaping the relative crisis resilience have been focused on the type of exchange rate regime and not on the policy options actually adopted (e.g. see Berkmen et al., 2012, Blanchard et al., 2010a; Tsangarides, 2012).[4] Our empirical strategy consists of two complementary steps. Firstly, we look for similarities in monetary authorities' responses to the global financial crisis. The goal is to identify similar emerging market economies in terms of monetary policy tools used to accommodate external shocks. This stage of analysis is a missing link between theoretical considerations and empirical research, and it is meant to serve as a substitute for the commonly used exchange rate regime classifications. Secondly, we examine the differences in the economic growth performance during the most intense phase of the crisis between the groups of emerging market economies. This stage is more in line with the existing empirical literature, however, our approach is focused on the effectiveness of alternative policy options oriented at crisis mitigation rather than on a sophisticated comparison between countries that peg their currencies with those that float.

The paper is structured as follows. Section 2 reviews the literature on a role of exchange rate regime during the global financial crisis and elucidates our contribution. Section 3 outlines the two-step methodological approach adopted and describes the data. Estimation results are presented in Section 4, while Section 5 provides concluding remarks.

[1] For a traditional approach to the trilemma see Mundell (1963) and Fleming (1962). For the modern approach and economic consequences of the trilemma see, e.g., Aizenman et al. (2010), Obstfeld et al. (2005, 2010).

[2] The literature on a choice of exchange rate regime is ample. For a survey see Klein and Shambaugh (2010) or Rose (2011).

[3] For a thorough study on emerging markets' resilience to the global financial crisis see Didier et al. (2012).

[4] For the sake of clarity, it ought to be emphasized that a lot of other explanatory variables, like the magnitude of trade shock, crisis vulnerability, or internal imbalances, have been taken into account in these studies. However, they have no connections with the actual monetary policy during the most adverse stage of the crisis.

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