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Fear of Declaring: Do Market Care What Countries Say About Their Exchange Rate Policies?

Discussion by

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Fear of Declaring

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Aims and features of the paper

*Examine **a** potential reason why countries may show "fear of declaring," which is taken to describe cases where "there is a disconnect between their exchange rate policy and their actual level of exchange rate intervention".*

- *"fear of declaring" is **asymmetric**, in the sense that it refers to cases where the **declared** regime is more flexible than the **de facto** regime, as there is a non-trivial extent of FOREX intervention.*

Aims and features of the paper

- *The paper examines whether international capital markets reward countries de jure "floaters" with* ***lower interest rate spreads***
- *A critical building block of the analysis rests on the assumption that* ***foreign exchange market intervention is effective***
- ***Along the way, the authors examine some of the macroeconomic factors that influence spreads***

Empirical strategy

- *Country risk is measured by spreads—specifically EMBI-G spreads. The spreads are quarterly 1997:4-2006:2 for anywhere between 22 and 31 countries*
- *The extent of de facto exchange rate flexibility is measured by an intervention index that is directly linked to the variability of international reserves (this index is calculated for 1980-2006)*
- *This index is 0 under a pure float and 1 in a peg*

A FOREX intervention index

$$INTERV = \frac{\left(\frac{\partial IR}{BM}\right)^2}{\left(\frac{\partial E}{E}\right)^2 + \left(\frac{\partial IR}{BM}\right)^2}$$

Empirical strategy

- *Countries are ranked for the most flexible to the least according to the intervention index for the entire sample and three subperiods*
- *Spreads are regressed against a plausible set of macroeconomic fundamentals the intervention index and the de jure exchange rate regime*
- *There are robustness checks in the form or exploratory regressions that include interaction terms, dummy variables, etc.*

Main findings

- *Spreads are lower in countries that have a fixed exchange rate regime-de jure or de facto (the coefficient on the "intervention index" is negative and significant across most specifications)*
- *There are, however, several caveats to the above finding (for example, as when the RR measure of the de facto regime replaces the intervention index)*

Critique: sample selection bias

- *The sample of countries is limited by the authors' measure of country risk (the EMBI-G spread). With the exception of at* ***most*** *3-4 countries (depending on the period), every country in that group of 22-31 has DEFAULTED! (many of them more than once)*
- *These defaults were accompanied by spectacular currency crashes—currency risk and default risk are* ***not*** *orthogonal in this sample*

Solution to sample selection bias

- *Enlarge the sample to include countries that have had currency crashes WITHOUT defaulting*
  - *i.e., the additional OECD countries for which the intervention index is calculated are candidates.*
- *As Calvo and Reinhart 1999 show, this latter group of countries have currency crashes WITHOUT getting downgraded by the rating agencies—capital markets may not "punish" greater exchange rate flexibility in such cases*

More on the sample

- *A sample of nine years may be on the short side for analyzing the potential link between the exchange rate arrangement and country risk*
- *Hence the authors may want to consider other measures of country risk*
  - *For example, Institutional Investor ratings are available since 1978 for over one hundred countries.*

A critique: the intervention index

- *The variability in gross reserves is a very poor measure of the extent of intervention (as discussed in Calvo and Reinhart)*
- *Furthermore, intervention in countries where there are capital controls is a very different animal from cases where capital mobility is high*
- *In effect, an earlier literature suggests that in the latter case--intervention is not effective in the first place*

A critique: the intervention index

- *Intervention can be effected through:*
  - *the purchases or sales of foreign currency debt (a la Brazil)*
  - *the purchases or sales in the derivative markets (a la Thailand)*
  - *the use of credit lines (the use of thee during the ERM crisis is a particularly good example)*
  - *"moral suasion" or plain arm twisting of banks (a la Egypt)*

The intervention index: some examples

- *Are Uruguay (.48) and Brazil (.43) second in flexibility only to Japan (.30) and more flexible than Australia (0.66)?*
- *Was Mexico "more flexible" in the 1980s (.37) than in 2000s (.79)?*
- *I don't think so—look at the denominator and high inflation*
- *Is China (0.85) more flexible than New Zealand (0.87)?—capital controls make a difference*

In conclusion

- *The paper takes an important step in trying to understand how capital markets reward or punish certain types of exchange rate arrangements –it is important to understand this as there are "fashions" in these arrangements.*
- *Along the way, the paper also sheds light on some of the key macroeconomic determinants of country risk—the findings on the role of public debt are particularly interesting.*