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Abstract: This paper discusses exchange rate behavior in what we call a peripheral monetary economy. First, it analyzes the essential properties of an open monetary economy, stressing the notions of assets' own rates of interest, liquidity preference, uncertainty, and conventions. The paper also approaches the historical and institutional peculiarities associated with the way in which peripheral economies are integrated into the existing international monetary and financial system (so-called financial globalization in the post–Bretton Woods era), and reappraises the idea of “peripheral condition.” Against this background, it examines the characteristics of exchange rate behavior in these economies.

Key words: exchange rates, monetary economy, Keynesian economics, center–periphery.

The purpose of this paper is to discuss the determinants of exchange rate behavior in peripheral monetary economies that adhered to the process of financial globalization and became “emerging” economies. Since the late 1990s, the policies of managed exchange rate (fixed or exchange rate bands) prevailing in these countries culminated in successive crises and were replaced by floating exchange rates. However, while most emerging countries adopt such rules de jure, in practice the monetary authorities try to curb the volatility of their exchange rates through active intervention in currency markets. Therefore, the prevailing exchange rate regime in these countries after the financial crises of the mid-1990s (which started with the Mexican crisis of 1994–95 and culminated in Argentina’s crisis of 2002) is the “dirty” floating regime, with different degrees of intervention.

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What drives the systematic interventions of central banks in the peripheral economies’ currency markets (the “fear of floating,” cf. Calvo and Reinhart, 2002) is the need to contain the excessive volatility of floating exchange rates, which is much higher than in “center” countries, and/or the adoption of defensive strategies in the midst of an international financial environment marked by the instability of capital flows, especially those directed to the periphery. This defensive behavior is manifested through attempts to reduce external vulnerability by preemptive accumulation of foreign reserves (a “precautionary demand” for reserves for the purpose of meeting unforeseen requirements, e.g., capital flow reversals) and/or establish a competitive level of exchange rates under export-based growth policies (Aizenman et al., 2004; Carvalho, 2010; Dooley et al., 2005).

The post Keynesian approach to the determination of exchange rates is a valuable contribution to the understanding of the dynamics of exchange rates in the historical context of the international financial and monetary system that emerged after the collapse of the Bretton Woods regime (see, e.g., Davidson, 1982, 1998, 2000; Dow, 1999; Grabel, 1996, 1999; Harvey, 1991, 1999, 2006, 2009; Schulmeister, 1988). The chief trait of this approach is the idea that short-term capital flows play an effective, autonomous function in the determination of exchange rates. Currency prices depend heavily on dealers’ and foreign investors’ portfolio decisions. Thus, expectations are of utmost importance.

However, this literature does not provide a comprehensive explanation of the historical peculiarities associated with the emerging peripheral economies, such as why the volatility of their exchange rates tends to be comparatively higher. To proceed with this explanation, we will fall back on Keynes’s and the post Keynesians’ ideas on the properties of a monetary economy, in particular, asset pricing, as well as discuss the hierarchical and asymmetrical traits of the international monetary and financial system, revisiting the structuralist idea about the nature of the “peripheral condition.”

This paper argues that, presently, in open monetary economies, exchange rates are influenced predominantly by short-term capital flows (and speculation in the assets market), which, in turn, are a function of expectations (highly volatile) of the relevant agents in these markets. It

1 “[T]he precautionary demand refers to the liquid balances held against uncertainty, that is, to protect the country against the possibility of suffering adverse shocks. . . . For a country, guarding against adverse shocks that may reduce or interrupt cash inflows or increase outflows may be the most important motive to retain reserves” (Carvalho, 2010, pp. 270–271).
will focus on the institutional structures that substantially affect individual (inter)subjective assessments that must be made in situations marked by difficulties in forecasting and by recurring changes that require sudden and rapid revisions of expectations and conventions (though they may be interspersed with periods of stability).

Moreover, due to the monetary and financial asymmetries of the post–Bretton Woods period, changes in agents’ state of expectations idiosyncratically affect the peripheral orbit. The currencies of emerging peripheral countries have a lower liquidity premium in relation to the key currency and other convertible currencies. Thus, in times of increasing uncertainty, these assets are the first victims of the “flight to quality” (i.e., to assets denominated in the key currency) by global investors. On the other hand, in situations marked by an excess of international liquidity and a higher appetite for risk, or eagerness to bet against the uncertain future (lower liquidity preference), when, normally, conventions (and expectations) about the future trajectory of the economy are more optimistic, and interest rates in core countries are lower, “emerging assets” incorporate a high expected appreciation, which compensates for their lower liquidity premium (i.e., the attribute \( a \) exceeds the “yield” or return implicit in the liquidity premium \( l \)) and, thus, become assets highly demanded by international investors. That is, although their \( l \) is structurally low, their total returns \( r_a \) can be cyclically high enough to offset the former. Governments and central banks can influence the values of the attributes of assets according to policy objectives. However, this ability depends on the size of foreign reserves (the larger the reserves, the lower the volatility of \( a \)) and on the degree of financial openness (the higher it is, the lower the value of attribute \( c \)).

The essential properties of an open monetary economy

For Keynes (1933), modern economies are monetary economies in the sense that money is not neutral and crucially affects motives and decisions of economic agents, as much in the short as in the long run. Money is a means of storing wealth, and as such becomes an asset, that is, it becomes an alternative to other means of accumulating wealth, especially in contexts of pronounced uncertainty regarding the future.

In a monetary economy, all assets, including money, have specific attributes (in greater or smaller degree), namely (cf. Keynes, 1936, ch. 17; Carvalho, 1992, ch. 5): (a) the expected quasi-rent (or “yield”; cf. Keynes, 1936, p. 225), \( q \); (b) the carrying cost, \( c \); (c) the liquidity premium, \( l \) (a “power of disposal” that confers a “potential convenience or
security”; cf. Keynes, 1936, p. 226); and (d) the expected appreciation, $a$. The combination of these attributes determines an asset’s own rate of interest ($r_a$) (or its total expected return):

$$r_a = a + q - c + l$$

(1)

It is a characteristic of money that (in low, moderate inflation regimes) its yield is zero, its carrying cost and expected appreciation are both insignificant, but its liquidity premium (a nonpecuniary return) is considerably high (actually, the highest among all assets).

Liquidity preference is expressed as a trade-off between the monetary returns ($a + q - c$) and the liquidity premium ($l$), which all assets possess in different degrees. This dilemma is reflected in the way in which agents structure their portfolio, that is, how they manage their stock of wealth over time. More specifically, in a monetary economy with such characteristics, liquidity is strongly valued in times of higher uncertainty regarding the future, justifying an increased demand for money as an asset, or for its close substitutes, so as to structure a portfolio that is as liquid as possible, while one waits for more auspicious circumstances in which one can hold less liquid assets that may, however, generate higher overall returns. Thus, greater uncertainty lowers $q$ of all assets (except money) and increases the demand for money as an asset because the attribute of liquidity premium becomes highly cherished. Thus, liquidity preference plays a crucial role in the determination of expenditure decisions. It is in this sense that one may assert that money has short- and long-term implications on the “real side” of the economy. Given the logic of capitalist accumulation and the ubiquitous existence of uncertainty, in particular situations there will be a clear preference for money and its closer substitutes, since they are the liquid assets par excellence, and the postponement of real investment plans.

Liquidity preference is a kind of rational (defensive) behavior under genuine, fundamental Keynesian uncertainty (nonquantifiable, nonprobabilistic, and nonergodic). Liquidity preference and uncertainty are closely related. The Keynesian theory of liquidity preference is an antipode to the idea of efficient financial markets (and the associated concepts of rational expectations and fundamentals). For instance, Davidson (1998, 2000) argues that financial markets cannot be efficient. In a “nonergodic” world, one cannot believe that the data available at

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2 The concept of uncertainty alluded to here is obviously the one consistently developed, since Keynes, by Shackle (e.g., 1972, 1979), Davidson (e.g., 1994), Lawson (1988), Runde (1990), Dow (1995), Vercelli (2002), and Dequech (2000), among others.
every moment provides a reliable and safe guide for decisions that will have concrete results in an uncertain future. Under these conditions, the main function of financial markets is to provide liquidity. This “liquidity function” (Davidson, 1998, p. 282) requires the ability to buy and sell assets in orderly, well-organized markets, so that it is always possible to acquire the asset (money or currencies) that makes it possible to settle debts. Rules and institutions should be created to ensure that liquid markets work in a well-organized way.

If the main role of financial markets is to offer liquidity in an organized way, then the issue of efficiency is not relevant. In the real world of modern capitalist economies, “efficient markets are not liquid and liquid markets are not efficient” (Davidson, 2000, p. 6). Accordingly, the hypothesis of efficient markets, as typical to approaches inspired in the old “classical” tradition, limits the role of money and finance to the short term at best. An orderly market requires a regulating institution known as the market maker: the agent or institution that publicly announces the disposition to act promptly as a residual buyer and/or seller so as to ensure stability in case of a sudden destabilizing change affecting either demand or supply. The market maker, based on previously announced and known rules of that market, must make sure that, after a disturbance or shock, the market price will not chaotically differ from the recently observed price. In situations in which abrupt changes in demand or supply can generate ample variations in market prices, the market maker must intervene so as to limit excessive market price fluctuations (cf. Davidson, 1994).

Besides liquidity preference, the other typically rational answer of agents who need to make prospective calculations and make strategic decisions in an uncertain environment is the resort to conventions. Accordingly, Keynes (1936, ch. 12; 1937a, 1937b) characterizes conventions in the following way: (1) Current market conditions provide a reasonable guide for decision making (under “normal” conditions, agents tend to give little importance to future changes). (2) Agents presume that the current state of opinion, as expressed in prices and in production, is based on a correct summary of the future perspectives of the economy, which they accept until something new and relevant comes up (Keynes, 1936, p. 152; Keynes, 1937a, p. 114). In other words, agents’ decisions are based on inductive reasoning, on the belief that “the future will resemble the past” (Keynes, 1937b, p. 124). (3) Moreover, Keynes emphasizes the intersubjectivity of the agents’ actions. Since they believe that their knowledge is “limited, vague and uncertain” and that other agents might be better informed than they are, the individual agent tends “to conform
with the behaviour of the majority or the average opinion” (Keynes, 1937a, p. 114).³

Thus, conventions emerge because agents have limited, uncertain knowledge concerning the different relevant factors affecting their decisions as well as on the results of these decisions. Under fundamental uncertainty, conventions function as an anchor to decision-making processes. Conventions act as a kind of “substitute for the knowledge which is unattainable” (Keynes, 1937b, p. 124). They are a kind of tacit social knowledge, generated from past experiences and from agents’ interactions in time and space. Conventions are the embodiment of a kind of knowledge that was generated through intersubjective action in historical time.⁴

In an open monetary economy there is a specific dimension of financial markets, namely, the foreign currency markets, where the relevant agents hold a specific class of assets, which we will call “currency assets.” As with any other asset, agents hold currency assets because they favorably price their total expected returns. However, the application of this general account based on asset pricing has to be mediated by the historical circumstances of modern capitalism. Agents’ actions are embedded in the institutional context in which they are performed. One important historical peculiarity is the existing globalized monetary and financial system that emerged after the collapse of the Bretton Woods regime.

In this setting, essentially, (portfolio) capital flows drive exchange rates—and foreign currencies are similar to financial assets. Since currencies are held as a portfolio capital asset, Equation (1) can be used to represent this behavior. For example, if \( r_{an} > r_{am} \), then currency \( n \) appreciates relatively to currency \( m \). Thus, the process of price determination (total expected returns calculation) of these assets can be represented through the variables (attributes) of this equation. Therefore, it is necessary to understand the attributes \( a, q, c, \) and \( l \) of currency assets in order to comprehend currency market behavior.

Currency assets pricing is peculiar due to the distinctive traits of these assets, such as strong exchange rate volatility. This means that variable \( a \) (the expected appreciation of the currency) will tend to be highly volatile and subjective. Furthermore, in the case of “emerging”

³ Note that the idea of convention is similar, but not equal, to the notions of “bandwagon behavior” (Harvey, 1991, 1993; Schulmeister, 1988) and “mimetic behavior” (e.g., Orléan, 1999). They are similar in the sense that it is rational to imitate other agents’ behavior.

⁴ On the issue of intersubjectivity, see the many contributions in Fullbrook (2002).
peripheral currencies, the volatility tends to be higher. Thus, the other historical peculiarity that should be taken into account is the existence of a core–periphery structure, which conditions the behavior of exchange rates in peripheral monetary economies. To understand the specific behavior of a in the case of these currencies, as well as the other attributes of these peculiar assets, we need to contemplate other ingredients in the analysis, among which is the hierarchical and asymmetrical nature of the international monetary and financial system.

The post–Bretton Woods era and the peripheral condition: peculiar institutional features and their influence on the dynamics of exchange rates

Crucial events that took place in the 1970s involved a strengthening of the process of internationalization of capital. A particular aspect of this process, and quantitatively the most significant, is the increasing integration of financial markets. The critical ingredients of the growth of global financial markets were the breakdown of the Bretton Woods system of fixed exchange rates (inducing higher disposition for diversified currency holdings and for speculation in currency markets), the domestic financial deregulation process, the dismantling of capital controls, and the fast development of international financial markets (mainly derivatives and capital markets, related to the process of securitization). In this context, technical progress in the computer and information technology industry has facilitated massive transfers of financial assets among markets (cf. Bryan, 1999).

As suggested by François Chesnais, financial globalization refers to the elimination of internal barriers among the different segments of financial markets and to the interpenetration of national monetary and financial markets, as well as to their integration in globalized markets (Chesnais, 1996, pp. 10–11).

Thus, the post–Bretton Woods context can be characterized by the following: (1) higher volatility, with exchange rates, interest rates, and assets prices subject to large short-run fluctuations; (2) a high degree of contagion, with financial turbulence spreading from the epicenter of the system to countries and markets that apparently have no relation to the original problem (even to those considered to have “sound” macroeconomic policies).

These characteristics are associated, in turn, with the contours of the contemporary international monetary and financial system. Agents’ higher liquidity preference, the volatility of capital flows and, for this
reason, the volatility of the currency markets, result from: (1) the nature of the key currency (the fiduciary dollar); (2) the combination of floating exchange rate regimes with free capital mobility (which has stimulated strong speculation in currency markets, as well as short-term capital (in/out)flows, causing these markets to become even more volatile); and (3) the dynamics of the current international financial system, governed by financial globalization and by the predominance of capital markets.  

As highlighted in the post Keynesian literature (e.g., Davidson, 1998, 2000; Dow, 1999; Grabel, 1996, 1999; Harvey, 1991, 1999, 2006, 2009; Schulmeister, 1988), in this specific historical context, short-run capital flows play an active and autonomous role in the economy and constitute the chief determinant of exchange rate dynamics. Thus, a major issue in the post Keynesian approach has to do with the underlying factors that determine agents’ expectations in currency markets in an environment of uncertainty.

Harvey (1999, pp. 201–203) analyzes the types of demand for foreign currency (namely, trade flows, foreign direct investment, portfolio investment, and official reserves management) and highlights the leading role of portfolio investment, which is inherently unstable and subordinated to the logic of short-term capital gains and, therefore, the main reason for the volatility of exchange rates. The investors’ expectations concerning the movements of the prices of assets determine both the path of exchange rates and the current prices of these assets.

If the returns of assets are strongly related to changes in exchange rates, these changes become one of the main targets of portfolio investment. Thus, current exchange rates would depend on the expectations concerning their future trend, as in other financial markets. However, contrary to other assets, the currency itself does not need to be an object of speculation:

This is really no different from any other asset market, except, interestingly, that the currency itself need not be the direct object of speculation. Nevertheless, because the exchange rate is such an important part of the value of any international asset, the potential of fluctuations must be carefully considered. Speculators need never have foreign money as the object of their desire, and yet it will play a central role, both affecting and being affected by portfolio capital flows. (Harvey, 1999, p. 206)

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5 For an analysis of the implementation and consequences of financial liberalization programs in developing countries, as well as the particular (deleterious) issue of portfolio investment inflows into these countries, see Grabel (1996, 1999).
Thus, what explains the volatility of exchange rates in the post–Bretton Woods environment is that they are influenced by investors’ appetites for capital gains in the short run. Sudden changes in expectations regarding future movements of the exchange rates generate rapid changes in current prices.6

Portfolio flows govern transactions in the currency markets, and expectations concerning the future evolution of exchange rates are the main determinants of the current rates:

Today’s prices are created by the weighted (by liquidity and confidence) average of market participants’ expectations of tomorrow’s price. Agents are not, as in rational expectations, forecasting an event that is independent of their actions—they are creating the event (Davidson 1982–83). Realized outcomes clearly affect the exchange rate, . . . but even then the current structure of the currency market means that they do so primarily through expectations. [A currency] moves more in reaction to the announcement of a trade imbalance than from the pressures created by the imbalance itself. (Harvey, 2009, p. 42)

Dealers and portfolio investors would also take into account (when deciding to buy or sell foreign currency) the expected liquidity of assets. This attribute would depend on specific factors as well as on the currency in which the asset is denominated: liquidity increases if the currency in which the asset is denominated is one in which a considerable array of goods and services are priced or if it is the de facto or de jure international reserve currency (the dollar has benefited from both of these since World War II) (Harvey, 2009, p. 85).

In sum, in the globalized monetary and financial system that emerged after the collapse of the Bretton Woods regime, a crucial determinant of agents’ decisions as to which currency to hold in their portfolio is the exchange rate (both current and expected). Exchange rate changes reflect changes in the speculative positions of agents (driven by a given state of

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6 Harvey (1999, 2006, 2009) argues that sudden changes in expectations can in turn be explained by the interaction of six factors: (1) the speculative nature of currency markets; (2) the absence of an anchor for the value of the exchange rate; (3) the influence of uncertainty on agents’ decisions; (4) the amplifying effects of “bandwagon behavior”; (5) the particular form of decision making, which relies on “heuristics” (“rules of thumb”) and tends to simplify the decision-making process; and (6) the “specific culture” (“subculture”) of agents who act in the currency markets. This term, borrowed from the institutionalist analysis, refers to the pattern of behavior (and underlying values associated with a given institutional and social environment) of a particular group of agents. In the case of currency markets, the agents responsible for most transactions (dealer banks and portfolio investors) would be especially prone to the pursuit of short-term profits in high-risk operations, since their jobs and rewards depend on the profits of these operations.
expectations) who operate in strongly interconnected currency markets, much more than changes in the trade patterns among the different nations (cf. Harvey, 1999).

The previous Keynesian framework is the starting point for the study of the determination of exchange rates in countries referred to here as “emerging,” a notion that, in this article, applies to the capitalist peripheral countries that engaged in the process of financial globalization.

In turn, the “peripheral condition” results from a given economy’s structural insertion in the international division of labor, which can be seen as organized in two poles, as expressed in the center–periphery metaphor.\(^7\) This metaphor can be interpreted in terms of asymmetries and heterogeneities concerning:

- the creation and dissemination of technical progress;
- the national innovation systems as a key institutional structure for the endogenous generation of technical progress;
- production structures;
- typical patterns of income distribution and employment creation;
- the degree of autonomy of economic policies; and
- last but not least: the fundamental structural peculiarity associated with both the position in the hierarchy of currencies and the monetary nonconvertibility, which contributes to macroeconomic instability and, therefore, to higher exchange rate volatility.

This issue, about the importance of financial and monetary relations, as well as financial market dynamics, especially currency markets, has not received due emphasis in the structuralist literature (both the “classic” and the “neo,” according to Lustig’s taxonomy, 1988), which tended to focus more on the phenomena and processes operating in the peripheral economies’ “real side.” Nevertheless, as it is crucial, this “missing link” needs to be recovered.

The international monetary system comprises a hierarchical, asymmetrical institutional arrangement organized around a key currency, the dollar, which has a privileged position. In other words, there is a hierarchy/asymmetry of currencies issued by the other center countries and those issued by the emerging peripheral countries (Herr, 2006; Plihon, 2010). The hierarchy among currencies engenders structural volatility in emerging peripheral economies, making them especially vulnerable to capital flight and their currency markets more susceptible to volatile short-term capital flows.

\(^7\) A recent, updated statement of this approach can be found in Ocampo and Martin (2003).
In order to understand the behavior of exchange rates in the emerging peripheral countries, it is necessary to take into account their position in the current international monetary system. Besides the superior position of the key currency (the fiduciary dollar), placed at the top of the currency hierarchy (and, for that reason, the one with the highest \(l\)), this system is marked by asymmetries cutting across the currencies of the center countries at the top and those of emerging peripheral countries at the bottom (those with the lowest \(l\)), which conditions the behavior of currency markets in the latter.\(^8\)

The monetary asymmetry refers to the hierarchical dimension of the international monetary system. Currencies are hierarchically positioned according to their degree of liquidity, which relates to these currencies’ ability to perform internationally the three functions of money: medium of exchange, unit of account (and denomination of contracts), and store of value (international reserve currency). The key currency is placed at the top of the hierarchy because it has the highest degree of liquidity (the maximum liquidity premium \(l\) at a global scale). The currencies issued by the other core countries are in intermediate positions, and are also liquid currencies. They are used as well as a means of denomination of contracts at an international scale and are demanded as a store of value by foreign investors (they have a high liquidity premium \(l\), but not as high as the dollar). At the opposite end are the currencies issued by the emerging peripheral countries, which are nonliquid currencies, for they are incapable of performing those functions, even marginally. These currencies (qua assets) are priced with a lower liquidity premium, although they might be demanded according to the expectations regarding shifts in the value of attributes \(a\), \(q\), and \(c\). For instance, in any given circumstance, a low-\(l\) currency could have a higher \(r_a\) than a high-\(l\) currency. This fact expresses the condition that the hierarchy of currencies is not about total returns, but about liquidity.

The asymmetry of the international financial system is superimposed on that of the international monetary system and it has two dimensions. The first one concerns the rationale of capital flows directed to emerging countries. These flows ultimately depend on exogenous sources, which cause these countries to be permanently vulnerable to their reversal by virtue of changes in the phase of the economic cycle and/or changes in the economic policy of the centre countries, as well as by the increase in the liquidity preference of global investors. The second dimension

\(^8\) Cohen (1998) adopts the concept of a “monetary pyramid” to classify the different types of currencies, which should be distinguished according to their degree of “monetary internationalization.”
of financial asymmetry concerns the marginal insertion of emerging countries in the global capital flows. In spite of the growing participation of assets issued by these countries in the portfolios of investors in the core economies over the 1990s and 2000s, this participation is still residual (Obstfeld and Taylor, 2004). In these sense, these countries are price takers.

The mutually reinforcing monetary and financial asymmetries have two important consequences for the path of currency markets in these countries. First, these markets are particularly vulnerable to the inherent volatility of capital flows, ultimately determined by an exogenous process. At points of reversal of the cycle, of monetary/fiscal policy changes in the center or of increase in the liquidity preference, emerging financial assets, with the lowest $l$, are the first victims of the global investors’ “flight to quality,” as they cannot function as store of value and, therefore, cannot be a receptacle of uncertainty on a global scale.

Second, the fact that a marginal proportion of capital flows is allocated in these countries also contributes to the greater volatility of their exchange rates. As the instability of placements is generally larger in the case of foreign assets in relation to domestic assets (Pléhon, 1996) (i.e., investors tend to more frequently reassess their investment decisions in foreign assets), in the case of “emerging” assets, this instability is still more pronounced, given the equally marginal effects of their sales on the profitability of global portfolios.

However, despite the residual nature of capital flows directed to emerging peripheral countries, the potentially destabilizing effects of these flows on their financial markets and exchange rates are significant, since the volume allocated by global investors is not marginal in relation to the size of these markets (Akyüz and Cornford, 1999).

Furthermore, because in most of these countries financial markets are not as liquid and deep, sales by foreign investors significantly reduce security prices, with important consequences on the other segments of the financial market (Studart, 2001). In the case of totally or partially “dollarized” markets (securities with an exchange rate adjustment clause), the potential feedbacks among fixed-income and exchange rate securities are more pronounced given the currency mismatch. In this context, a currency depreciation caused by the reversion of flows contaminates the price of securities and, thus, affects the financial position of domestic debtors (Griffith-Jones, 1995).

After the financial crisis of 2007–8, this participation increased at a faster pace due to the better economic performance (current and expected in the next years) of emerging countries (see IIF, 2011).
Besides causing large fluctuations in the exchange rates of the emerging peripheral countries, the nonliquid nature of their currency contributes both to a higher exchange rate risk, which affects the relation between domestic and external interest rates, and a higher country risk premium in relation to the key currency.

Thus, under these circumstances, the liquidity premium $l$ and the expected appreciation $a$ are of utmost importance, since it is by means of their assessment that agents in currency markets make decisions regarding which assets to demand and in what quantity. The higher country risk premium and exchange rate risk of assets issued by emerging peripheral countries, which are expressions of the smaller liquidity premium of their currencies on an international scale, make them the first victims of movements of the “flight to quality” at times of high aversion to risk as a result of the previously described monetary and financial asymmetries.

If investors leave these countries swiftly, this may deteriorate even more, placing further pressure on local policymakers to raise the policy rate (with the aim of increasing $q$ and $a$), as well as to deepen the financial openness (namely, remove capital controls) to reduce $c$. If this policy is successful, $(a + q - c)$ will increase and compensate for the lowest liquidity premium $l$.

Usually, the harmful side effect of such policies is a fall in aggregate demand, and therefore, in output, income, and employment levels. Moreover, the inflow of portfolio investment induced by these policies produces two harmful, mutually reinforcing outcomes on emerging peripheral countries: “the exacerbation of constraints on policy autonomy; and the increased vulnerability of the economy to risk, financial volatility and crisis” (Grabel, 1996, p. 1763).

In this context, the “self-insurance” strategy of foreign reserves accumulation (“precautionary demand,” cf. Aizenmann et al., 2004; see also Dow, 1999, pp. 156–157; and Carvalho, 2010) would amount to a defensive, rational response by these countries in the context of globalized finance by increasing their potential capacity for sustaining a desired level of international liquidity (and of exchange rate stabilization) in times of capital flows reversals. In this case, the central bank acts as a market maker par excellence.

In fact, in currency markets, central banks of each country, whether they operate in isolation or as a group, informed by their domestic policy goals, act as market makers in their currency markets, with the purpose of controlling exchange rate volatility and, particularly in emerging peripheral economies, keeping exchange rates at a competitive level and/or accumulating foreign reserves. Thus, governments and central banks
have the power to influence the values of some currency assets attributes according to policy objectives, subject to constraints. This power, in turn, depends on both the size of foreign reserves and the degree of financial openness. The larger the foreign reserves, the greater the central bank capacity to reduce the volatility of \( a \). Furthermore, the higher the degree of financial openness, the lower \( c \) will be.

On the other hand, in periods of international liquidity excess, when the appetite for risk is higher (i.e., when the animal spirits of investors are more pronounced), emerging assets become objects of desire on the part of global investors because of the expectation of appreciation (increase in \( a \)) of their respective currencies (associated with the favorable interest rate differential and/or with the perspective of capital gains in the stock markets with relatively lower price/profit ratios, which increase \( q \)), compensating for their reduced liquidity premium \( l \).

**Concluding remarks**

This paper attempted to advance the understanding of exchange rate behavior in peripheral countries that have engaged in the process of financial globalization, thus becoming “emerging” economies.

In order to achieve this goal, the paper discussed the essential properties of an open monetary economy. Next, it applied the Keynesian idea of assets own rate of interest (total expected returns) to the currency markets in a specific historic context (the monetary and financial system that emerged after the collapse of the Bretton Woods regime), where the relevant agents hold a specific class of assets, which we called “currency assets.” Moreover, to comprehend the peculiar dynamics of these markets, it also contemplated the structural and institutional peculiarities that condition the behavior of exchange rates in emerging peripheral economies. After reassessing the idea of “peripheral condition,” the paper highlighted the historical specificities associated with the form of integration of emerging peripheral economies in the current international monetary and financial system.

The paper reached a few important conclusions. First, it emphasized the idea that, currently, in open monetary economies, exchange rates are influenced predominantly by short-term capital flows (and speculation in the assets market), which, in turn, are a function of expectations (highly volatile) of the relevant agents in these markets. Keynesian notions such as asset pricing, liquidity preference and conventions are crucially strategic to interpreting these phenomena. Thus, the narrative that emerges is not of markets characterized by efficiency, stability, and “optimality” (governed by the elusive concept of “fundamentals”),
but rather by institutional structures that substantially affect individual (inter)subjective assessments that must be made in situations marked by difficulties in forecasting and by recurring changes that require sudden and rapid revisions of expectations and conventions (though they may be interspersed with periods of stability).

Second, due to the monetary and financial asymmetries of the post-Bretton Woods period, changes in agents’ state of expectations idiosyncratically affect the peripheral orbit. The currencies of emerging peripheral countries have a lower liquidity premium in relation to the key currency and other convertible currencies. Thus, in times of increasing uncertainty, these assets are the first victims of the “flight to quality” (i.e., to assets denominated in the key currency) by global investors. On the other hand, in situations marked by an excess of international liquidity and a higher appetite for risk, or eagerness to bet against the uncertain future (lower liquidity preference), when, normally, conventions (and expectations) about the future trajectory of the economy are more optimistic, and interest rates in core countries are low, “emerging assets” incorporate a high expected appreciation, which compensates for their lower liquidity premium (i.e. the attribute $a$ exceeds the “yield” or return implicit in the liquidity premium $l$) and, thus, become assets highly demanded by international investors. That is, although their $l$ is structurally low, their total returns $r_a$ can be cyclically high enough to offset the former. Moreover, governments and central banks can influence the values of $q$, $c$, and even $a$, according to policy objectives. However, this ability depends on the size of foreign reserves (the larger it is, the lower the volatility of $a$) and on the degree of financial openness (the higher it is, the lower the value of attribute $c$).

In view of this, policymakers in emerging peripheral countries should try to keep or reinforce the strategy of foreign reserves accumulation and, simultaneously, reduce the degree of financial openness with the adoption of “capital management techniques” (cf. Epstein et al., 2004). These techniques include the traditional menu of capital controls, but add a set of prudential financial regulations (such as restrictions on banks operations in foreign currencies). There is often a great deal of synergy between prudential financial regulation and traditional capital controls because particular types of prudential financial regulation actually function as a form of capital control, and, moreover, capital controls can operate as, or complement, prudential financial regulation.

Furthermore, there is not a trade-off between reserves accumulation and capital controls. With the adoption of dirty floating regimes by many emerging peripheral countries after the crises in the 1990s, a new role
has emerged for the management of capital flows. In these regimes, capital management techniques can reduce these countries’ vulnerability to financial crises, increase the degree of autonomy of policymaking processes, and are a supporting tool for exchange rate and monetary policies in times of boom and bust of capital flows. In times of boom, they control the destabilizing effects of short-term capital flows as well as the cost and risk of reserve accumulation; in times of bust, they reduce the minimum level of reserves needed to restrain speculative attacks and alleviate pressures on domestic interest rates.

REFERENCES


