

Economic Views – Parallel FX Rates in EM



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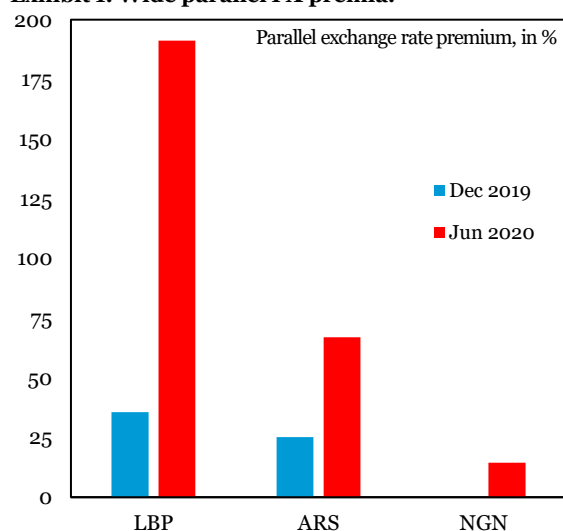
June 23, 2020

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- Parallel FX rates have arisen in Argentina and Lebanon, ...
- often trading at a substantial premium to official rates.
- But can these rates predict the path of the official rate?
- They often do but we find many exceptions to the rule.
- In Argentina, a wide premium predicts FX intervention.

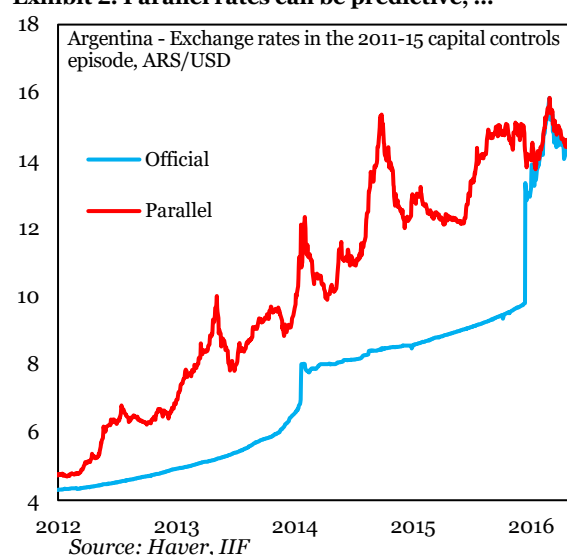
One of the features of the crises in Argentina and [Lebanon](#) is the combination of capital controls and managed official exchange rate regimes. Since controls unavoidable ration the amount of FX that can be traded at the official exchange rate, parallel exchange rates emerge and often deviate from official rates (Exhibit 1). In this context, it is crucial to ascertain how much information the parallel rate contains about the future direction of the official rate. Is it just a weak sentiment signal from a distorted market or does it predict where a unified exchange rate would go under a normalized outlook? We study systematically 27 past episodes where parallel rates traded at wide premia and look at whether the official rate eventually followed the parallel. In roughly two thirds of episodes, including Argentina 2011-15, the official exchange rate did depreciate to close the gap. In other words, the parallel rate was a good predictor. However, the official rate did not converge fully to the more depreciated parallel rate in the remaining cases. We also show that the central bank is more likely to sell dollars when the parallel premium widens.

Exhibit 1. Wide parallel FX premia.



Source: Haver, IIF

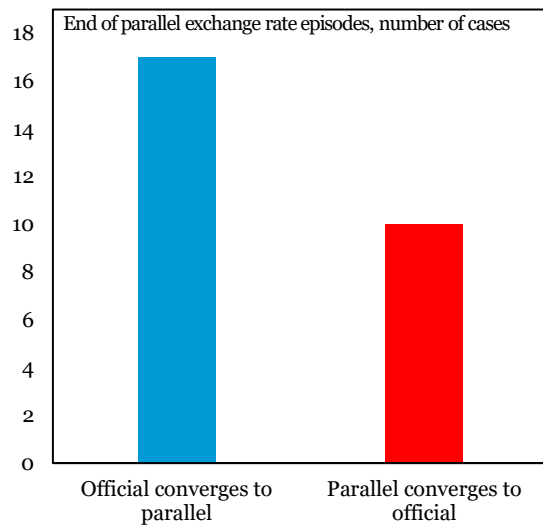
Exhibit 2. Parallel rates can be predictive, ...



Source: Haver, IIF

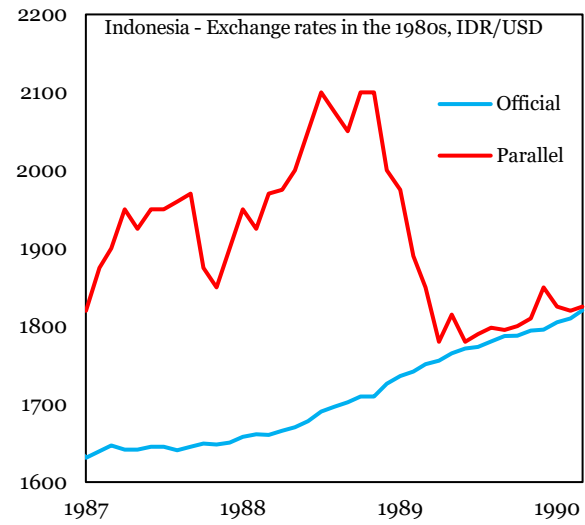
Argentina and Lebanon have managed exchange rates. The former is a de facto crawling peg and the latter a formal peg. In both cases, the authorities have resorted to restrictions on FX transactions to help close external financing gaps. Since these measures limit how much FX can be traded at the official rate, a more depreciated parallel market arises. [Nigeria](#) is in a qualitatively similar situation but the parallel premium remains fairly contained. Premia in Argentina and Lebanon reached more than 100% in the recent past. It is hard to tell if in a normalized regime with no capital controls the official rate would depreciate so much, but we can at least evaluate what happened in similar past episodes. We use the exchange rate database by Ilzetzki, Reinhart, and Rogoff (2019) to identify episodes where EM parallel exchange rates traded at a premium of more than 20% persistently. Since 1960, we identify 27 such episodes in 11 countries. We consider an episode concluded when the premium falls below 10% consistently. The median episode lasts five years and the average full-sample premium is 91%. The most recent episodes we document are Argentina 2011-15 and [Venezuela](#) 2016-19. In both cases the official exchange rate depreciated all the way to the parallel rate upon unification. Argentina's 2011-15 episode is qualitatively similar to today's, with the official exchange rate crawling under heavy capital controls. When the official rate floated and controls were lifted, the official rate shot up, matching the parallel rate (Exhibit 2). In this case, the informational content of the parallel rate was high. In Venezuela, the official rate also converged to the parallel in mid-2019 but hyperinflation and extensive distortions across markets make it less of a relevant benchmark.

Exhibit 3. ... but not universally, ...



Source: Ilzetzki et al. 2019, IIF

Exhibit 4. ... as the Indonesia case shows.

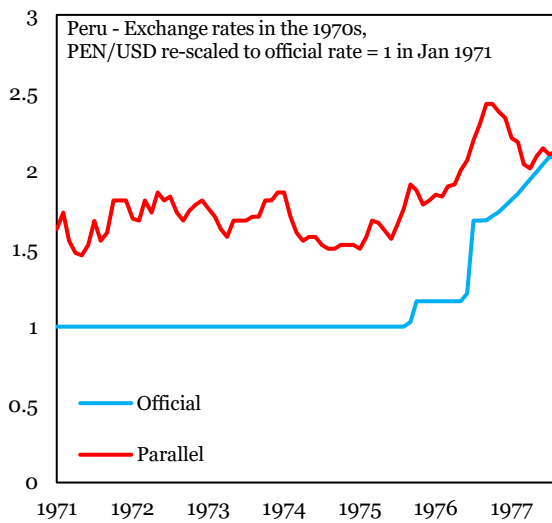


Source: Ilzetzki et al. 2019, IIF

Should we conclude from recent experience in Argentina and Venezuela that the parallel rate provides the “right” market signal? History paints a more nuanced picture. In 10 out of 27 episodes, the official exchange rate did not jump up to the parallel upon removal of restrictions (Exhibit 3). In these cases, the parallel rate was “too depreciated” and was not a good predictor of rates under unified regime. Exhibit 4 shows the Indonesia case in the 1980s, where the parallel rate did not predict the official rate. Some episodes in this group are countries “saving a peg.” For example, India managed to close a premium of 100% in the early 1970s without abandoning the pegged exchange rate (so did Indonesia in the 1960s). However, other pegged regimes like Peru’s in the 1970s went the opposite way (Exhibit 5).

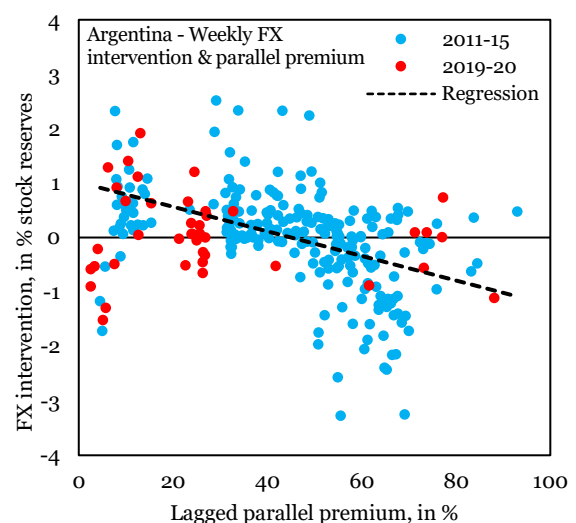
A separate but related issue is whether the parallel FX premium tells us something about reserve losses while multiple exchange rates coexist. The central bank may choose to supply dollars to the market if it believes a wide premium can eventually put undue pressure on the official rate. We test this hypothesis in Argentina, where we have weekly data on FX intervention during the 2011-15 episode. We find a robust statistical relationship between the parallel premium on a given week and FX intervention the week after (significant at the 1% level with an explanatory power of 20%). A 10pp increase in the parallel premium lowers net FX purchases by 0.2% of the stock of reserves. Put simply, we are more likely to see FX sales by the central bank when the parallel premium widens.

Exhibit 5. Right signal from Peru’s parallel rate.



Source: Ilzetzki et al. 2019, IIF

Exhibit 6. FX premia predict reserve losses.



Source: Haver, IIF