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- Large currency devaluations have a decidedly bad name, ...
- because they tend to be associated with chaos and disruption, ...
- even as the “dominant currency paradigm” clouds the lift to exports.
- With EM currencies under continued pressure since COVID began in 2020, ...
- we update our earlier work on large devaluations and their impact on exports.
- We survey all real and sustained devaluations in excess of 20 percent since 1980.
- On average, export volumes receive a substantial boost across these episodes, ...
- while import volumes fall sharply early on, helping rebalance the current account.
- As EM struggles to boost growth, currency devaluations are part of the solution.

EM currencies have been under pressure since COVID swept the globe in 2020. As the Fed now approaches the formal start to QE tapering – the first step towards policy normalization – depreciation pressure on EM FX is intensifying and worrying policy makers, likely one reason why EM central banks are well into an aggressive hiking cycle. The implicit “fear of floating” isn’t justified in our view. EM didn’t have anything like the policy space of the G10 during COVID, with countries doing far smaller fiscal stimulus and unable to do meaningful QE. Given this constraint, currency devaluation should be part of the toolkit, but instead it has a bad name, something the “dominant currency paradigm,” by casting doubt on the export lift from devaluation, has only added to. We survey all real devaluations around the world since 1980 that have been larger than 20 percent, were persistent and didn’t reverse an earlier overvaluation. The evidence is clear that export volumes receive a substantial lift across episodes, with median annual growth in export volumes almost doubling from 4.6 percent before devaluation to 8.1 percent after. The export channel works, which means devaluation should be part of the EM toolkit as part of a strategy to boost growth.

Exhibit 1. Many EM currencies are down a lot, ...

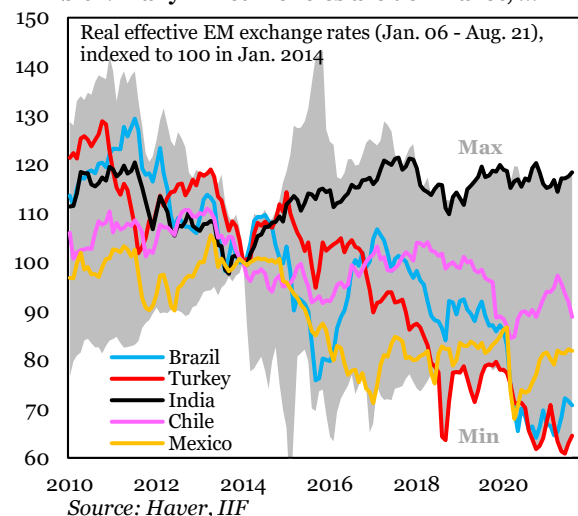
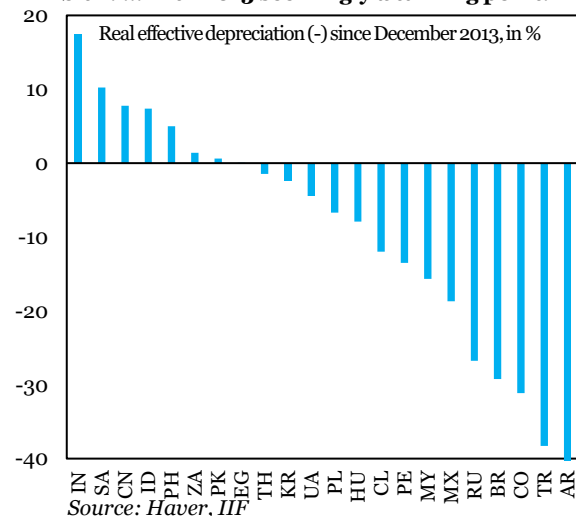


Exhibit 2. ... with 2013 seemingly a turning point.



Many EMs have seen their currencies fall substantially in real terms (Exhibit 1), with 2013 – the year of the taper tantrum – a turning point (Exhibit 2). Currency devaluations have a bad name, not least since the “dominant currency paradigm” casts doubt on the lift to exports. We screen EM for large devaluations, focusing on three criteria: (i) the real trade-weighted currency falls more than a given threshold within two years; (ii) the devaluation is sustained for at least three years, i.e. is not unwound quickly; and (iii) the devaluation does not reverse an earlier overvaluation, i.e. the currency drop isn’t just a reversal of a previously high level. We start with a 30 percent threshold and find only nine episodes since 1980: Mexico (1994), Indonesia (1997), Russia (1998), Brazil (1998), Argentina (2001), Uruguay (2001), Egypt (2002), Ukraine (2013) and Egypt (2016). Exhibit 3 shows yearly data for the level of the real exchange rate, where the black line gives the median level across our 9 episodes in event time, with period t denoting the year prior to devaluation. The grey bands around this line give the min-max range for real exchange rates across episodes. The blue line shows Turkey, pink is Argentina and purple is Brazil. Period t for these three countries is 2017, i.e. prior to the start of the EM sell-off in 2018. The scale of depreciation in all three cases is near the bottom of the min-max band, i.e. these declines are extreme by historical standards. The solid black line in Exhibit 4 shows median export volumes across these episodes, while the solid blue line shows the same for imports. Since this is a small sample, we also explore a lower threshold of 20 percent, which gives us 24 episodes. The dotted lines in Exhibit 4 show the same thing for this broader sample. Across samples, median export growth rises substantially from the five years before to the five years after devaluation. In the smaller sample, it goes from 3.4 to 9.0 percent annually, while in the larger sample it rises from 4.6 to 8.1 percent. The export channel from currency devaluation works.

Exhibit 3. We screen for large real devaluations, ...

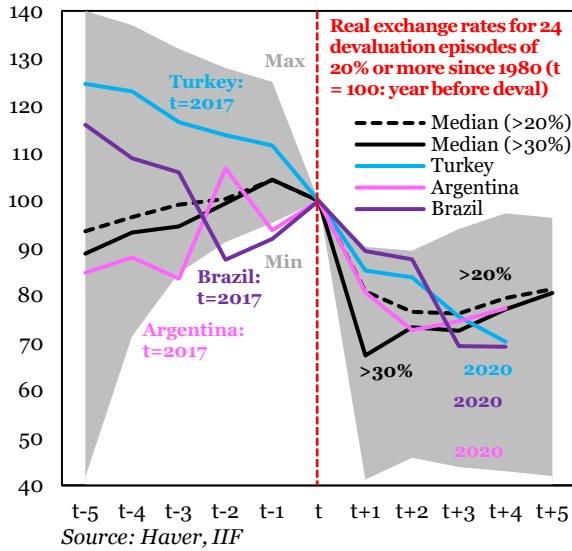
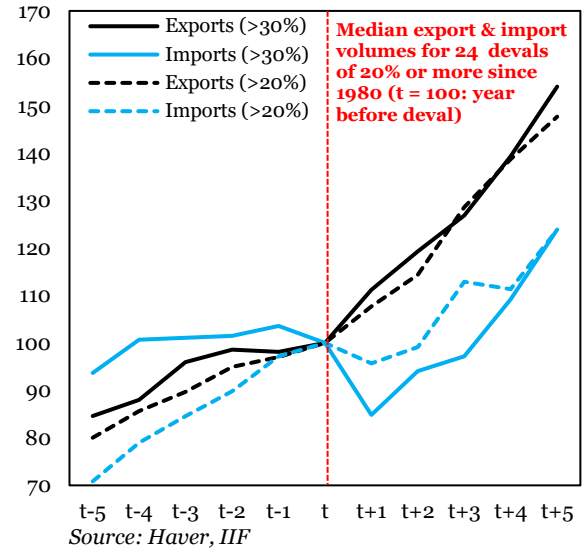


Exhibit 4. ... finding 24 episodes above 20% since 1980.



Of course, it is always hard to know what to do with historical averages. We now look at the specific examples of Turkey and Brazil, which have experienced large and sustained real devaluations. Exhibit 5 shows that export volumes have seen a substantial lift, while Exhibit 6 makes clear that import volumes are down, especially when controlling for large credit expansions in Turkey. Devaluations don't deserve the bad name they have. We thus think they need to be part of the policy mix in EM, as countries recover from COVID and aim to lift growth in a sustainable manner.

Exhibit 5. Export volumes got a large boost, ...

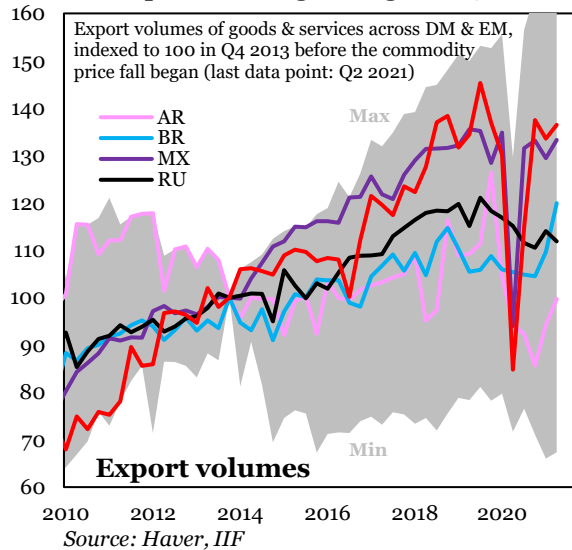


Exhibit 6. ... while import volumes tended to fall.

