

EXCHANGE RATE FLEXIBILITY ACROSS FINANCIAL CRISES

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NON-TECHNICAL SUMMARY

Most currencies in the world are more or less linked to the dollar or the euro, even if very few of them have strictly fixed exchange rates. Up to now, the use of the euro as an anchor currency has been confined to Europe, its immediate vicinity and some African countries, leaving the rest of the world to the US dollar influence. The long-lasting prevalence of the US dollar as an anchor currency has however been more and more challenged for several years and some evolution has begun to take shape, especially since the start of the present financial crisis. Many countries have loosened the link of their currency to the US dollar in the global financial crisis that started in July 2007, a fact that may be explained by relying on the literature on contagion across markets.

Spillovers from advanced financial markets to currencies in emerging countries stem from the same causes documented in the literature on contagion, such as the drying-up of investors' liquidity, the rise in risk aversion, and the updating of their risk assessments. Consequently, interdependencies across currencies are likely to be exacerbated during crisis periods.

In this paper, we try to address these issues by answering the following questions: (i) Have exchange rate policies been modified in the sense of a greater flexibility since the start of the financial turmoil in July 2007? (ii) Is this evolution in line with what happened during previous crises? More generally, we aim at investigating the linkages between currency markets in emerging countries and financial market strains in the global economy. We expect that the co-movements between these two types of markets are exacerbated in episodes of financial turmoil.

To check these hypotheses more precisely, we start by measuring the exchange rate policies by their degree of flexibility, which itself is proxied by the volatility of the exchange rates for a sample of emerging countries. Then, we study the relationships between currency flexibility and various proxies for stress on global financial markets. We introduce the possibility of non-

linearities by running smooth transition regressions (STR) over a sample of 21 emerging countries from January 1994 to September 2009. The results confirm that exchange rate flexibility does increase more than proportionally with the global financial stress, for most countries in the sample. We also evidence regional contagion effects spreading from one emerging currency to other currencies in the neighboring area.

JEL Classification: F31, G15, C22.

Key Words: Financial crises, dollar pegs, contagion effects, nonlinearity.