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Using Minsky to analyze Fragility of Exchange Rates in Emerging Markets

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The article suggests an analysis of emerging market's exchange rates through the lens of Hyman Minsky's work: the Financial Instability Hypothesis and Money Manager Capitalism (MMC). Recently, with the development of MMC in advanced economies and liberalization policies in some emerging market countries, these countries started receiving substantial financial flows from "money managers". We argue, however, that as a country receive such flows its exchange rate starts following a cycle of endogenously increasing fragility in relation to any international development that affect money managers' portfolios.

The analysis is done by a transposition of Minsky's framework to open economies. The units of interest are money managers (pension funds, hedge funds) which, in order to ensure the continuity of their funding, seek to maximize the total return of their portfolios. These can be distributed (in times of MMC) among assets of different countries: i) the same country as where they have their funding from, ii) another advanced economies, and iii) emerging markets. An element that differentiates these three options is the exchange rate and its impact on returns: it plays no role in the first case, but is important in the second, and is a main element of uncertainty in the third case. The margins of safety of money managers vary accordingly, being the lowest in the third one. Following Minsky's typology, this characterizes three different types of units: hedge, speculative and Ponzi.

The exchange rate is therefore crucial in this context, and so is its expected value. It is after a period of stable exchange rates in emerging countries that some money managers reassess their past decisions as too conservative and decide investing in these countries. This is the change that will trigger the cycle: because money managers' investment impact exchange rates and provide liquidity ensuring its stability, other investors will decide investing in these countries, what further impacts exchange rates. Hence, money managers' own actions validate their decisions. This moment of continuing investments and appreciating exchange rates characterizes a stability of conventions (following Orlean): a moment when agents share the same belief about the market and have their expectations guided in the same direction. As long as the convention reveals adequate to the economy it wants to explain, it will hold. In the case analyzed in the paper, the convention is that emerging markets exchange rates will continue appreciating, making investments in these assets (and the return of Ponzi units) profitable and stable.

The end of Minsky's original cycle is subject to debate: it can be endogenous - the interest rates rise due to the booming economy making debt servicing more difficult; or exogenous - led by any shock. In the analysis of exchange rates, the cycle will end when the convention established when money managers decided investing in these countries fall into crisis. This happens in a moment when it is no longer able to explain the actual developments, in this case, a depreciation, that can happen in two cases: if 'contrarian' or 'skeptical fundamentalists' traders manage to deviate the trend (as analyzed by Orlean); or due to an important change in any other determinant of exchange rates. With the crisis of the convention, money managers will sell-off their asset, and the resulting the deflation concern not only these assets but also the exchange rate in which they are traded.

From the point of view of the emerging markets this pattern of investments by money managers means a pressure for cyclical determination of their exchange rates; and a well-determined pattern can also increase the weight of financial flows in the determination of exchange rates. This "enlarged Minskian framework" informs our understanding about how these exchange rates are determined; including, very importantly, an explanation of why they so often fall into crises.

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