Evaluation of Exchange-Rate, Capital-Market, and Dollarization Regimes in the Presence of Sudden Stops

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Summary

What economic effects are expected from the choice of an exchange rate and capital market liberalization regime? The paper focuses on these issues and their implications. We develop a methodology suitable for evaluations of balance-of-payments' regimes and open capital markets depend on the probability international capital inflows come to a sudden stop.

Macroeconomic theory has long recognized many positive growth effects of the exchange rate peg regime. By fixing their currencies to international moneys (the Dollar or the Euro), fiscally-disciplined emerging economies, could rapidly accumulate exchange reserves through export growth, able to maintain a high saving ratio, provide certainty to business, profit margins to investors. Based on a low and stable domestic rate of interest, such an emerging economy could retain the confidence of the international investors. Consequently, the peg may lead to a good overall economic performance: high output growth, and low inflation.

However, every major international economic crisis of the past 15 years (save Brazil in 2002) has been rooted in rigid exchange rate regimes. Since 1994-Mexico, in 1994, Thailand, Indonesia and Korea in 1997, Russia and Brazil in 1998, and Argentina and Turkey in 2000-has in some way involved a fixed or pegged exchange rate regime. At the same time, countries that did not have pegged rates-among them South Africa, Israel in 1998, Mexico in 1998, and Turkey in 1998-avoided crises of the type that afflicted emerging market countries with pegged rates.

The "original sin" concept explains the consequences of abrupt departures from an exchange rate peg regime due to a sudden stop of capital inflows, for emerging markets. The phrase refers to the inability of a country to borrow abroad in its own currency, because no foreign creditor is willing to gamble on the potential exchange rate instability. A plausible explanation for the widespread use in dollarized debt is that countries are forced into this position because their monetary and fiscal policies lack credibility. If a country issued debt in domestic currency, it would have an incentive to inflate its way out of debt. Investors, who expect that the government will succumb to such temptation, refuse to buy domestic currency- denominated debt papers. The paper analyzes the role played by such dollarization in sudden stops crises and link the analysis to the issue of regime evaluations.

We find evidence for the trade-offs arising from switching from exchange-rate float to a peg and from capital controls to liberalization of the capital markets. On the one hand, the risk of sudden stops crises is affected, on the other hand economic efficiency is affected so that the two effects have conflicting influence on macroeconomic performance.