Financial Constraints and Exchange Rate Flexibility in Emerging Market Economies

December 2001

Michael B. Devereux
Hong Kong Institute for Monetary Research
University of British Columbia
CEPR

Summary

Since the financial crises of the late 1990s, there has been an active debate about the appropriate exchange rate policies for emerging market economies. While there is some degree of consensus that intermediate exchange rate regimes are no longer feasible, there is less agreement on whether emerging market economies should move towards freely floating exchange rates, or adopt a hard peg, currency board, or fully dollarize.

This paper makes a contribution to this debate by first providing some evidence on the response of the East Asian economies to the crisis of 1997-99, and then by developing a model that is consistent with this evidence. The evidence suggests that the rapid depreciation of currencies in the Asian crisis was associated with a restriction of trade credit to exporting firms in many of the East Asian countries, preventing the natural positive export supply response to a real depreciation. Our theoretical model captures this phenomenon by amending a standard small economy macroeconomic framework to include trade finance constraints. Following a rapid and sudden episode of capital outflows, the trade finance constraints may impinge so tightly on the economy that the real depreciation is associated with a fall rather than a rise in export production. The model can be used to evaluate the appropriate monetary policy stance for emerging market economies that are vulnerable to rapid movements in flows of capital. The essential message of the paper is that the standard optimal currency area (OCA) analysis of exchange rate regimes, used heavily in the debate on the costs and benefits of the European single currency, for instance, is not a fully appropriate framework for evaluating exchange rate regimes in emerging market economies.