ELSEVIER

Available online at www.sciencedirect.com

SCIENCE DIRECT®

Emerging Markets Review 6 (2005) 289–307

EMERGING MARKETS REVIEW

www.elsevier.com/locate/econbase

Fear of floating and domestic liability dollarization

Adam Honig *

Department of Economics, Campus Box 2201, Amherst College, Amherst, MA 01002-5000, United States

Received 7 March 2005; received in revised form 10 June 2005; accepted 28 June 2005

Abstract

Previous attempts to analyze the effect of liability dollarization on "fear of floating" have focused exclusively on the role played by foreign liabilities. Liability dollarization of the domestic banking system, however, poses a similar risk as dollar-denominated deposits and credit impose a source of currency risk on domestic banks and firms, respectively. Findings from a large cross-country sample indicate that domestic liability dollarization plays a central role in producing a "fear of floating" among emerging market countries and developing nations. This is an important result because domestic liability dollarization is more reversible than the dollarization of foreign liabilities, providing a reason for optimism that these countries can regain flexibility in the choice of exchange rate regime and overcome their "fear of floating."
© 2005 Elsevier B.V. All rights reserved.

JEL classification: F33; G21

Keywords: Fear of floating; Unofficial dollarization

1. Introduction

The optimal currency area literature (Mundell, 1961; McKinnon, 1963) provides valuable insights into the choice of exchange rate regime in advanced economies. Unfortunately, this decision is more complicated for emerging markets and developing nations, which face a host of additional concerns. A serious issue that has received much

* Tel.: +1 413 542 5032; fax: +1 413 542 2090.
E-mail address: ahonig@amherst.edu.

1566-0141/$ - see front matter © 2005 Elsevier B.V. All rights reserved.
doi:10.1016/j.ememar.2005.06.001

recent attention is the dollarization of liabilities.[1] Unhedged foreign-currency-denominated liabilities are a major source of vulnerability for both firms and banks because large depreciations can lead to significant reductions in net worth (Mishkin, 1996; De Nicoló et al., 2005). This process can lead to sharp contractions in output and is one of the reasons why many emerging markets exhibit a "fear of floating" (Calvo and Reinhart, 2002). Specifically, emerging markets are concerned about large exchange rate movements, particularly large depreciations, because of the effect on balance sheets, and thus policymakers limit exchange rate volatility. This restricts their ability to conduct independent monetary policy. Mishkin and Savastano (2001), for example, point out that liability dollarization poses problems for inflation targeting regimes as the monetary authorities are unable to ignore movements in the exchange rate. In fact, many emerging markets and developing nations have chosen to fix their exchange rates, completely abdicating their role in monetary policy, as the only solution, even though this may be a sub-optimal outcome. For these reasons, liability dollarization is one of the central issues in open economy macroeconomics.

Micro-level evidence of the effect of real depreciations on firm balance sheets, a fundamental cause of "fear of floating," has been presented in a number of studies. Harvey and Roper (1999) find that balance sheet effects played a significant role in the Asian crisis. They argue that Asian corporations issued significant amounts of foreign currency-denominated debt and were counting on fixed exchange rates to persist. Concern among policy makers about balance sheet effects is a primary reason why Asian firms bet on currency stability. This was a risky bet as foreign currency borrowing left these firms vulnerable to an exchange rate depreciation. The *Emerging Markets Review* published a special issue analyzing balance sheet effects from firms in six Latin American countries. Most of the included studies found negative balance sheet effects of deprecations on investment. In the case of Argentina, for example, Galiani et al. (2003) argue that the large share of dollar-denominated debt provided an implicit guarantee against a large depreciation. In the event that a depreciation would occur, the high level of liability dollarization would provide political pressure to protect dollar borrowers.

While these studies analyze micro-level data on firms in a small sample of countries, this paper uses a large cross-country sample of aggregate data on liability dollarization. A cross country study allows for an explicit test of an effect of liability dollarization on the choice of exchange rate regime; in other words, a test of "fear of floating." The analysis in this paper extends to banks as well. The message, however, is similar: a large share of dollar debt, whether it is of domestic firms or banks, gives powerful incentives for policymakers to ensure currency stability, producing a "fear of floating."

To date, attempts to establish empirically the effect of liability dollarization on "fear of floating" have focused exclusively on the role played by foreign liabilities (Alesina and Wagner, 2004; Ganapolsky, 2003; Hausmann et al., 2001). Liability dollarization of the domestic banking system, however, poses a similar risk. When banks accept dollar deposits from domestic residents, they assume foreign exchange risk. Although banks make dollar loans to domestic firms in order to reduce currency mismatches on their

[1] Following the standard vocabulary, this paper employs the terms "dollar" when referring to any foreign currency and "peso" when referring to any domestic currency.

دریافت فوری ← متن کامل مقاله

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات