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The exchange rate regime and the currency composition of corporate debt: the Mexican experience

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Abstract

This paper analyzes the effect that the change from a fixed to a floating exchange rate regime that took place in Mexico in December 1994 had on the currency composition of corporate debt. In particular, the paper asks whether a fixed exchange rate regime biases corporate borrowing towards foreign currency due to an implicit exchange rate guarantee given by the government. Therefore, under a predetermined regime, firms will not fully internalize their exchange rate risk and will be more likely to engage in balance sheet mismatches than under a floating regime. We study the main determinants of foreign currency borrowing of those firms listed in the Mexican Stock Exchange from 1992 to 2000 to test whether balance sheet currency mismatches fell after the adoption of the floating exchange rate regime. The results found support the view that the floating exchange rate regime has been useful in reducing exchange rate exposure.
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1. Introduction

This paper analyzes the effect that the change from a fixed to a floating exchange rate regime that took place in Mexico in December 1994 had on the currency composition of corporate debt. In particular, the paper asks whether a fixed exchange rate regime biases corporate borrowing towards foreign currency due to an implicit exchange rate guarantee

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One key point in the current discussion on the reform of the international financial architecture is the impact of the exchange rate regime on financial vulnerability. One of the main channels through which the exchange rate regime can affect the vulnerability of an economy is through its impact on foreign currency borrowing. However, there is no clear consensus among economists regarding this last point.

On the one hand, several authors have argued that a pegged exchange rate is another variation of implicit guarantees. This is the case because to maintain this regime the monetary authority will always claim that the prospects of a change in the parity are nil. Through its constant denial of the possibility of a change in the parity, the authorities will be implicitly assuming part of the cost that the private sector would incur in the case of a devaluation. In these circumstances, private sector agents will have less incentives to hedge their foreign currency exposure.

These arguments have been made recently by many authors. The following quote from Fisher (2001) clearly states the biased incentives towards foreign currency borrowing in a pegged regime:

> *The belief that the exchange rate will not change removes the need to hedge and reduces perceptions of the risk of borrowing in foreign currencies.*

Along the same lines, Mishkin (1996) highlights the advantages of floating regimes:

> *Indeed, the daily fluctuations in the exchange rate in a flexible exchange rate regime have the advantage of making clear to private firms, banks and governments that there is substantial risk involved in issuing liabilities denominated in foreign currencies.*

On the other hand, without totally dismissing the implicit guarantees argument, several authors claim that some emerging markets have a natural tendency for liability dollarization that is more ingrained in the system than what can be explained by the presence of a pegged exchange rate regime. This has been termed the original sin hypothesis (see Eichengreen and Hausman, 1999). According to these authors:

> *This is a situation in which the domestic currency cannot be used to borrow abroad or to borrow long term, even domestically. In the presence of this incompleteness, financial fragility is unavoidable because all domestic investments will have either a currency mismatch (projects that generate pesos will be financed with dollars) or a maturity mismatch (long-term projects will be financed with short-term loans).*
> *Critically, these mismatches exist not because banks and firms lack the prudence to hedge their exposures. The problem rather is that a country whose external liabilities are necessarily denominated in foreign exchange is, by definition, unable to hedge.*

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