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Debt composition and balance sheet effects of currency depreciation: a summary of the micro evidence

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Abstract

This paper surveys recent empirical evidence on the determinants of the currency composition of debt, and on the impact of exchange rate fluctuations on economic activity. It suggests that Latin American firms tend to partially match the composition of their debt with the currency composition of their income stream but the liability dollarization can reduce or possibly reverse the typical Mundell–Fleming result of expansionary devaluations. © 2003 Elsevier B.V. All rights reserved.

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1. Introduction

During the second half of the 1990s emerging market countries witnessed a series of financial crises that gave new strength to the debate on the effects of real exchange rate fluctuations on economic performance. The ‘Tequila’ crisis of 1994–1995 and the Asian meltdown of 1997 led many observers to suggest that the presence of debt denominated in foreign currency can reverse the expansionary

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impact of exchange rate depreciations common to the standard Mundell–Fleming framework.¹

Krugman (1999a), Aghion et al. (2001, 2003) and Cespedes et al. (2002) were among the first to utilize what is now known as the open economy Bernanke–Gertler–Gilchrist framework to show that, in presence of foreign currency debt, currency depreciations may be contractionary.² Cespedes et al. (2002), for instance, show that the presence of liability dollarization (dollarization here stands for choosing debt denominated in any foreign currency) does not necessarily lead to contractionary depreciations. In particular, they show that depreciations can be contractionary only in presence of very large levels of foreign currency debt and large imperfections in the international capital markets.³ So, according to Cespedes, Chang and Velasco, the answer to the question ‘Does liability dollarization lead to non-standard effect of monetary and exchange rate policy?’ is ‘it all depends,’ or, as economists like to say, it is an empirical question.

Given that theoretical models do not yield unambiguous results ultimately the answer to the question of whether balance sheet effects may make currency depreciations contractionary (or the related question on which exchange rate regime should be adopted by emerging market countries) needs to be answered on empirical grounds. While some research has found that depreciations can be contractionary at an economy wide level, the precise channels through which this occurs and their quantitative importance still need to be identified.⁴ In particular, it is fundamental to assess whether there is any empirical evidence that supports the existence of a significant and sizeable balance sheet effect associated with the dollarization of liabilities at the firm level. If firms were perfectly hedged, currency depreciations should not have any relevant negative balance sheet consequences.

The papers collected in this issue provide evidence on the currency composition of debt and on the balance sheet effect of liability dollarization for real investment. All the papers share the characteristic of being based on detailed balance sheet data for large panels of firms. Many of the data sets had not been used previously for this purpose and they bring rich new evidence to bear on these important issues. The research on which these papers are based was conducted in the context of the

¹ Moreover, analysts have suggested that liability dollarization itself can play a leading role in provoking a self-fulfilling crisis. Discussions can be found in Dornbusch (1998), Krugman (1999a), Krugman 1999b; Calvo et al. (2003a,b) provide empirical evidence of the importance of liability dollarization as a predictor of sudden stops in capital flows for a sample of 32 emerging market countries. Previous work that focused on industrialized countries discussed that depreciation could be contractionary through an imported input channel (see for instance, Campa and Goldberg (1999) and Nucci and Pozzolo (2001)).

² In the standard closed economy Bernanke and Gertler (1989) model, a costly state verification set up makes the cost of capital depend (inversely) on the firm’s net worth. See also Gertler et al. (2003) for an application to the open economy.

³ In fact, Cespedes et al. (2002) find that the steady-state levels of debt and risk premia that are necessary to generate contractionary depreciations are unrealistically large.

⁴ In an empirical study using a panel of macro data for developed and developing countries, Galindo et al. (2003) find that devaluations have a contractionary impact in countries with heavy liability dollarization.

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