

Financial liberalization and the stability of currency pegs[☆]

Utpal Bhattacharya^{*}

Kelley School of Business, Indiana University, Bloomington, IN 47408 USA

Received 10 April 2002; received in revised form 1 July 2003; accepted 20 October 2003

Available online 4 February 2004

Abstract

This paper analyzes how the strategies of domestic firms borrowing abroad complicate the interaction between central banks and foreign exchange short sellers. If we define financial liberalization as the degree of freedom given to domestic firms to borrow abroad, we find that, in the early stages of financial liberalization, foreign borrowing does not affect the stability of the currency peg, but, in the advanced stages of financial liberalization, foreign borrowing destabilizes currency pegs. When this happens, we show that policies to curb currency short sellers have no effect. The paper thus formalizes the critical juncture where financial liberalization and currency pegs become incompatible policy goals.

© 2005 Elsevier B.V. All rights reserved.

JEL classification: G15; F31; F34; D84

Keywords: Corporate borrowing; Currency short sellers; Central bank intervention; Exchange rate pegs

1. Financial liberalization and the stability of currency pegs

At a casual glance, the IMF's attitude towards exchange rates seems extraordinarily erratic. In 1997 the Fund urged Asian countries to devalue or float their currencies. In 1998 it lent billions to Russia and Brazil to try to help them maintain their exchange rates. It has praised Hong Kong for its super-strict currency board, and feted Singapore for its flexible managed float. [Economist, January 30, 1999](#)

[☆] This paper has benefitted from comments from Franklin Allen, Gary Gorton, Campbell Harvey, B. Ravikumar, Richard Rosen and S. Viswanathan, and from seminar participants at KAIST (Seoul, Korea), Indiana and Wharton.

^{*} Tel.: +1-812-855-3413; fax: +1-812-855-5875.

E-mail address: ubhattach@indiana.edu (U. Bhattacharya).

To fix or to float a currency? This question has not been answered even after a century of debate.¹ It has tormented a number of countries, the most recent being Argentina. The basic argument in favor of fixing the currency is to recognize that a fiat currency has value because its users believe it will have value. Governments need to bolster this confidence by anchoring the currency. Anchoring also makes the currency stable, which has real economic benefits. The basic argument in favor of floating the currency is that, like all tradeable assets, its value should be determined by supply and demand without distortions. A floating currency allows a country to absorb external shocks through the exchange rate, and it allows it to conduct an independent monetary policy.

A few countries have opted to float their currencies, more or less freely (e.g., the United States). A few countries have decided to fix their currencies. These have involved currency boards, where a law guarantees a parity with another currency (e.g., Bulgaria), or even tighter currency unions, where national currencies are abandoned in favor of a supranational currency (e.g., the Euro). Many countries, however, have tried to have the best of both worlds, loosely tying their exchange rate either to a single foreign currency, such as the dollar, or to a basket of currencies. They have allowed their central banks to intervene in the foreign exchange market to defend the currency peg as long as it is feasible (e.g., Singapore).²

The purpose of this paper is to show that if a country allows its domestic firms to borrow abroad, it may find it difficult to keep its currency peg. This means that if countries find it beneficial to embark on a policy of financial liberalization, currency pegs would probably have to be abandoned.³ Countries would have to choose between floating their currencies or fixing their currencies; they cannot have it both ways.

This is not the first paper demonstrating the incompatibility of fixed exchange rates and international capital mobility. It has been widely known to macroeconomists that fixed exchange rates, independent monetary policy and international capital mobility cannot coexist. They refer to this as the “impossible trinity,” following Robert Mundell’s seminal work in the 1960s.⁴ The contribution of this paper is to provide another justification for this insight, a justification that arises as a result of the complex game played between central banks, foreign exchange short sellers and domestic firms borrowing abroad. We

¹ See [McKinnon \(1993\)](#) for an excellent historical review of the changes in the rules of international financial systems over the last century.

² For some recent history of central bank interventions in the foreign exchange market, see [Dominguez \(2003\)](#). For empirical work on this subject, see [Dominguez \(1990, 1992\)](#) and [Dominguez and Frankel \(1993\)](#). For a model that captures the strategic interaction between foreign exchange short sellers and central banks, see [Bhattacharya and Weller \(1997\)](#), and [Morris and Shin \(1998\)](#).

³ In this paper, the phrase ‘financial liberalization’ would mean liberalization of the regulatory environment with respect to the first dimension of the six dimensions identified by [Mahar and Williamson \(1999\)](#)—allowing residents to borrow abroad, abolishing credit controls, deregulating interest rates, allowing free entry into the financial services industry, making banks autonomous and privatizing banks. [Mahar and Williamson \(1999\)](#) find that between 1973 and 1996 there has been dramatic financial liberalization in the world. It has increased efficiency in the allocation of capital, but its effect on savings has been ambiguous. [Bekaert and Harvey \(1995\)](#) argue convincingly that liberalization could also be nonregulatory. Markets may be segmented in laissez-faire regimes, and markets may be integrated in restrictive regimes. We will not discuss this type of liberalization in this paper.

⁴ See [Obstfeld and Rogoff \(1995\)](#) for a lucid exposition of the issues.

Download English Version:

<https://daneshyari.com/en/article/9554741>

Download Persian Version:

<https://daneshyari.com/article/9554741>

[Daneshyari.com](https://daneshyari.com)