

Dollar Over-Borrowing and Financial Crises in Emerging Markets

In what currency shall emerging markets borrow? At first blush, it seems that the dollar is superior to emerging markets' local currency, since dollar interest rates are lower. However, the problem with dollar borrowing is that the exchange rate of a country is typically negatively correlated with its business cycle: When growth is high and firms are in good financial condition, the exchange rate appreciates, which relieves borrowers of part of their debt. When the economy enters a recession and firms' financial conditions worsen, then the exchange rate depreciates, which inflates borrowers' debts in local currency terms and thus makes their debts even harder to service. In the worst case, this can cause a full-blown financial crisis. Given this highly dangerous property of dollar debt, it is puzzling why so many emerging markets still take on massive amounts of it.

The existing literature has discussed a number of explanations for excessive dollar borrowing, which all make misguided government policy the culprit: they typically argue that the government distorts the private sector's incentives to properly insure against exchange rate risk, for example by guaranteeing a fixed exchange rate.

In my paper, however, I argue that dollar debt is dangerous for a reason that is independent of government policy. In emerging markets, there is a feedback effect between the exchange rate and firms' balance sheets, which consists of the following two parts: Firstly, when the exchange rate of a country depreciates due to some internal or external shock, this inflates the value of firms' dollar debts, which has a negative effect on firms' economic activity. Secondly, the resulting decline in economic activity entails a further depreciation of the country's exchange rate, and these two effects compound each other. However, an individual borrower is not aware of her feedback effect on the exchange rate and thereby on the rest of the economy. In technical terms, this creates a

negative externality on all other dollar-borrowers that makes the country as a whole more vulnerable to shocks.

The question of what causes over-borrowing in dollars has important implications for policy measures to prevent financial crises in emerging markets in the future. The finding that a mechanism inherent to the market economy is responsible for the vulnerability of emerging markets implies that mere improvements in the governance of a country – the solution that the international financial institutions seem to favor – are unlikely to solve the problem. Instead, active policy measures are called for to make firms internalize the risks that they impose on the rest of the economy when they borrow in dollars. These measures potentially include a tax on dollar borrowing or, better still, quantity restrictions on the amount of dollar debt that the private sector of an economy can obtain.