Indebted Interests: Why Governments Fail to Regulate Foreign Currency Borrowing

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Motivation

- Household FC borrowing is long-standing problem in many emerging markets/developing countries
  - Cheap, but risky: depreciation raises burden of debt payments
  - Important role in financial crises of 1990s, during and following 2008-2009

- Governments have macroprudential tools to address risks: Outright bans, quantitative/exposure limits
  - Such regulation can be welfare-improving (Korinek (2011), Jeanne and Korinek (2019))

- **Research question:** Why do governments fail to restrict foreign-currency borrowing?
Two primary disincentives to regulate FC debt

1. **Credit access effect**
   - “Let them eat credit” (Rajan (2010), Ahlqusit & Ansell (2017))
   - Restrictions constrain consumption, especially where LC debt is inaccessible or more expensive

2. **Valuation effect**
   - Novel mechanism: Restrictions signal concern about the future path of the exchange rate, risking depreciation today → rise in debt burden
   - If the XR were expected to be stable, no need for restrictions
   - E.g. Armored SUV/bodyguards might increase your chances of kidnapping – regulation paradoxically increases crisis probability
Theory: Political Disincentives to Regulate

Both effects stronger when:

1. Exchange rate is fixed:
   - Restrictions signal lack of commitment to peg, risk speculative attack
   - Floating rate regimes don’t face this commitment problem

2. Level of exposure grows
   - Larger constituency of borrowers suffer in consumption terms
   - Valuation effect is magnified

Model: Formalize this argument in model of the regulatory decision of fixed-rate policymaker facing risk of speculative attack (á la Morris & Shin (1998))
Empirics: Implications

Two empirical tests of theory

1. **Macroimplication:**
   - Fixed exchange rates reduce restrictions when FC debt exposure is high

2. **Microfoundation:**
   - Depreciations reduce government support among those with FC debt
Empirics: Macroimplication

Cross-national evidence

- Dependent variable: $\Delta$ in level of household FC Debt restrictions
  - Hand-coded data on restrictions in 74 EM/DCs (1999-2016) using IMF’s AREAER & CB/MoF sources; 1 = No Restriction, 5=Full ban

- Linear interaction model:
  - **Independent variables**: dummy variable for Fixed (Ilzetski et. al (2017)); (Lagged) household FC debt exposure (% share of total debt) (Corrales & Imam (2019), IFS)
  - **Lagged Controls**: Capital openness, financial development, trade dependence, GDP per capita, democracy, monetary independence, tradable sector share/employment, etc.
  - Country FE, errors clustered at country level
Empirics: Macroimplication

Figure: Marginal Effects of Exchange Rate Rigidity (Linear and Binning Estimates). Left panel uses dichotomous Fixed variable; Right panel uses IRR fine index.

Main result: Increases in the rigidity of exchange rates are associated with declines in FC debt restrictions when FC debt exposure is high; conversely, more rigid XR regimes are associated with increases in restrictions when FC debt exposure is low.
Do FC borrowers punish policymakers who deliver XR depreciation?

- **Data**: Survey data from Austrian central bank (OeNB Euro Survey) covering ten CEECs
- **Dependent variable**: Trust in government/cabinet of ministers (1=Trust completely; 5=Do not trust at all)
- **Estimation sample**: 2012-2013; N≈12,000

**Interaction model**:
- **Independent variables**: dummy variable = 1 if respondent has FC debt; 1-year percent $\Delta$ in EUR/LC XR from date of interview
- **Controls**: Standard demographic controls, FC Savings, EU trust, credit access, proxy for knowledge of exchange rate risk, inequality, inflation, unemployment, per-capita GDP, democracy
- **Regional & year FE, errors clustered at regional level**
Empirics: Microfoundation

**Figure:** Marginal effects of foreign-currency indebtedness for one-year changes in EUR/LC.

**Main result:** FX indebtedness associated with decline in gov. trust following a depreciation.
Conclusion & Contributions

- New evidence on how political incentives encroach into relatively understudied technocratic domain
  - Financial regulation not just about “regulatory capture” by firms—preferences of the public matter as well

- Communication matters for macroprudential policy
  - Not just about legitimacy and “social purpose” (Baker 2018)
  - Regulatory actions themselves have informational content and can alter expectations, and thus asset prices

- Another reason why fixed rate regimes end in crisis:
  - Disincentives to regulate risky debt, allowing it to grow to unsustainable levels
Thank you