

Indebted Interests: Why Governments Fail to Regulate Foreign Currency Borrowing

Andrew Rys

Johns Hopkins SAIS
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- 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), Ahlquist & 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

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 (à la Morris & Shin (1998))

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

Cross-national evidence

- Dependent variable: Δ 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

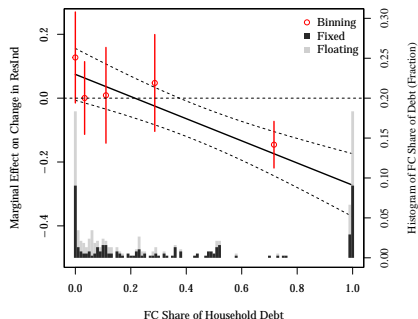


Figure: Marginal Effects of Exchange Rate Rigidity (Linear and Binning Estimates). Left panel uses dichotomous *Fixed* variable; Right panel uses IRR fine index.

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; $N \approx 12,000$
- Interaction model:
 - **Independent variables:** dummy variable = 1 if respondent has FC debt; 1-year percent Δ 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

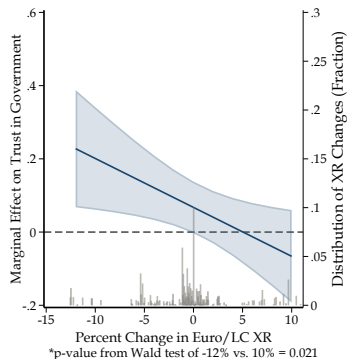


Figure: Marginal effects of foreign-currency indebtedness for one-year changes in EUR/LC.

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