

## **Exchange Rate Regime and International Overborrowing Syndrome**

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**April 2001**

According to Jeffrey Frankel – Harpel Chair Professor of Harvard University's School of Government – in the late 1960s, a view evolved that only a rigidly fixed exchange rate or a clean float would solve the problems that come with modern globalized financial markets. The hypothesis appears to be an apparent corollary to the "impossible trinity" – a country can pick only two goals from the tripartite menu of exchange rate stability, monetary independence, and financial market integration.

At the same time, taking international financial integration as given or inevitable, through a managed float a country can have some of both of the other two though neither complete exchange rate stability nor complete monetary policy independence. Monetary union and pure floating regimes appear to be preferable to the "soft middle ground of flexible rates", among other things, because they are invulnerable to speculative attacks. Complicated intermediate regimes may be insufficiently transparent to global investors. According to Frankel, most of the intermediate regimes that have been tried have failed, and often spectacularly so. Moreover, a number of them – Mexico, Thailand, Indonesia, Korea, Russia and Brazil – though formally pegged to the dollar when the crisis hit, were actually following a variety of middle regimes.

But pure floating is subject to large surges in exchange rates and speculative bubbles; and currency unions can be broken by political upheavals. Moreover, the conventional wisdom – countries should retreat from intermediate regimes because they are intrinsically unsustainable – tends to overlook one of the economist's stock in trade, namely that life involves tradeoffs and corner solutions are often not optimal.

A fixed exchange rate regime has advantages. In particular, it:

- reduces transactions costs and exchange risks that might discourage trade and investment; and

- provides a credible nominal anchor for monetary policy.

A floating exchange allows the country to pursue an independent monetary policy that accommodates negative real shocks without constricting demand.

The choice must weigh the advantages of more exchange rate stability against those of more flexibility. Besides, far from a simple dichotomy, the range of choices is a continuum of flexibility – from currency union to currency board through pegs (adjustable, crawling, basket, and target zones) before reaching the free float. IMF classification of 185 countries in late 1999 yielded the following:

- 51 independent floaters;
- 45 abandoned national currencies;
- 89 intermediate regimes.

Furthermore, recent research has shown that it is difficult to distinguish the floaters from the exchange rate targeters on the basis of exchange rate stability and foreign reserves changes. Theoretically, floaters should have less of both than the targeters, but this is not the empirical finding.

Clearly, the optimal exchange rate regime varies across countries and over time. There are good arguments to be made against the conventional wisdom limiting exchange rate regime choices to the extreme ends – firmly fixed or freely floating.

Recent financial crises in the 1990s, such as Mexico (1994) and East Asia (1997/98), have often been precipitated by large capital inflows. Financial liberalization enabled domestic firms, especially banks, to borrow heavily abroad resulting in massive, often excessive, inflows of foreign capital. This phenomenon has been called the "overborrowing syndrome". This was the source of macroeconomic imbalances that proved unsustainable.

Overborrowing is perhaps best dealt with as a moral hazard rather than as a matter of "getting the exchange rate right". This is the most suitable approach to the emerging markets' episodes. However, and of greater relevance to the Ghanaian situation of 1997/98 is the form of the syndrome resulting from an inconsistent macro policy regime.

Because wealth holders demand more compensation for holding developing country assets, the interest rates on assets denominated in cedis have to be higher to maintain international portfolio balance. This is the currency risk premium. In addition, there is a part of the interest differential between domestic and foreign currency arising from the (small) probability of a large sudden devaluation whose timing is unpredictable. Domestic operators that borrow with implicit government guarantees ignore the downside bankruptcy risks implied by such large devaluations. They also ignore ongoing volatility

in the exchange rate.

The current consensus in the academic literature, embraced by the IMF and other international organizations, is that more flexible exchange rate arrangements are to be encouraged. The argument is that with flexible exchange rate arrangements, the risks of accepting short-term foreign currency deposits by banks are clear. But while floating may reduce some of the risk premium (the probability of large devaluations). It does not necessarily reduce the currency premium. Therefore, a free-floating regime may not reduce moral hazard. This would appear to make a strong case for fixed exchange rates.

However, care must be exercised to avoid a 'bad' fix – one that obviously is unsustainable because of, say ongoing fiscal deficits and correspondingly high domestic interest rates that create a huge margin of temptation. In the absence of a good record of fiscal balance, a long-term commitment to maintain a stable or predetermined exchange rate regime would not be credible. No exchange rate, no matter how well chosen, can obviate the need for prudential regulation of domestic banks against undue risk-taking. The version of the overborrowing syndrome that afflicted Ghana was essentially the result of macro policy inconsistency – a 'bad exchange rate fix' especially but from 1997 to 1998. An expansionary fiscal stance and anti-inflationary and restrained monetary policy created a tendency to "unnatural interest rate disparities" and therefore an incentive to borrow abroad. Not only was there a high demand for external borrowing – working capital as well as investment capital – created, thanks, among others, to the IMF "certificate of good performance", the supply of external credits and loans was also encouraged as lucrative to foreign lenders. The result was large foreign exchange denominated liabilities on the books of domestic firms – from commercial (suppliers' credits) to industrial concerns (loans for the procurement of capital for expansion – Guinness, Ghacem, Aluworks, Unilever, Fan Milk) – and real estate agents (HFC).