

Moral Hazard, Financial Crises, and the Choice of Exchange Rate Regimes

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Abstract

We study the effect of the choice of exchange rate regimes on the likelihood of financial crises for a sample of emerging market and developing countries during 1990-2003. This relationship is tested through several channels of possible influences of exchange rate regimes on crises. We find that soft pegs and other intermediate regimes are associated with higher probabilities of financial crises than do the corner regimes, since they create incentives for unhedged foreign currency borrowings and excessive domestic credit expansion. We also test this effect through the channel of currency crises due to many evidence of a strong relationship between financial and currency crises, and find soft pegs being the most crisis prone type regimes. These indirect effects of exchange rate regimes on banking crises are robust primarily for a group of emerging market economies.

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