Essays on Currency Mismatches

Abstract

Emerging and developing economies are rapidly accumulating foreign currency denominated debt in recent years. Such debt leads to currency mismatches and indicates external vulnerability. The body of international finance literature, with few exceptions, ignored the importance of measuring the currency mismatches and examining the impact of such mismatches on the financial system and economic growth. This dissertation, consisting of three empirical essays on currency mismatches, strives to redress these omissions partially. The first essay adopts a new methodology to construct the aggregate effective currency mismatch index to overcome the limitations of extant approaches. With granular data on international debt securities, the essay documents the surging of currency mismatches at an alarming rate in Latin America, followed by Central Europe. The findings show that the global and domestic macroeconomic factors are responsible for growing mismatches in these economies.

Although a body of literature, still in its infancy, view currency mismatches as potential indicators of financial crises, no concrete empirical validation of this nexus is available. The second essay addresses this omission and examines the role of original sin and currency mismatches in financial crises. The essay develops broad original sin and new currency mismatch indices and employs machine learning methods to show that currency mismatches significantly increase the likelihood of financial crises. The third essay extends the broad original sin and new currency mismatch indices to examine the impact of external debt vulnerability on economic growth. The essay demonstrates that foreign currency exposure does cause an economic slowdown in advanced and emerging economies by escalating insolvency and systemic risk. The exchange rate movements adversely affect economic activity via the financial channel, blunting the trade channel effects. Overall, the dissertation shows that emerging and developing economies are not out of the woods yet. The thesis demonstrates the critical role of foreign currency assets and monetary policy independence in limiting currency mismatches and entrenching resilience. The macroprudential measures, monetary independence, foreign exchange reserves, and quality institutions are apposite to control mismatches.

***Keywords*:** Original Sin; Currency mismatch; Financial crisis; Economic growth.