

MISALIGNMENT, LIABILITIES DOLLARIZATION AND EXCHANGE RATE ADJUSTMENT IN LATIN AMERICA

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Abstract

Exchange rates in Latin America display a large volatility, constitute a central element of the policy strategies and their evolution have an important impact on financial stability due to the dollarization of liabilities which most countries exhibit. However, assessments on equilibrium exchange rates are scarce in the region. This paper aims at both filling this gap and analysing the impact of the adjustment of the exchange rates to equilibrium on financial stability. Building on the methodology of Alberola et al (1999,2002), we show that the stock of net foreign assets and the evolution of productivity are the fundamentals underlying the behavior of the real exchange rate. Using an unobserved components methodology in a cointegration framework, a time-varying equilibrium real exchange rate is derived, and deviations from this equilibrium provide an estimate of the degree of multilateral misalignment. The results uncover the large overvaluation of the Argentinean peso in 2001, and the moderate overvaluation of the Mexican peso, both of which are only partially explained by the estimated dollar overvaluation. The final part of the paper addresses the impact of liability dollarization on the adjustment of exchange rates. It is argued that the real exchange rate will tend to overshoot its equilibrium level, due to the need to foster higher current account surplus in the aftermath of depreciation to make up for to the increase in liabilities. An adjustment to account for this effect is performed on the previous results. This overshooting, when coupled with sudden stops of capitals, may help explaining the higher volatility of real exchange rates in the region.

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