The Effects of Financial Cooperation among Emerging Economies

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Abstract

This paper studies the effects of international financial cooperation among economies under credit constraints. The analysis is based on a two-good small open economy model that incorporates liability dollarization and an occasionally binding collateral constraint. I examine two types of cooperation, namely, emergency lending and a credit guarantee, both of which affects the collateral constraint. I compute welfare gains and change in crisis probability induced by each model under different size, interest rates, and degrees of business-cycle comovements. The results of the simulations show that a credit guarantee outperforms emergency lending both in terms of welfare gains and crisis probability. While a credit guarantee can increase welfare by loosening the collateral constraint and mitigating the effects of negative shocks, it could increase the probability of financial crises by worsening the overborrowing problem. When the business-cycle comovement of the source and recipient economies is strong, as in the case of some regional cooperations, the overborrowing problem would be less severe and a reciprocal credit guarantee could lower the crisis probability. The welfare of the two economies might also be improved, whereas the magnitude would be relatively small.

Keywords: Borrowing constraint, Credit guarantee, Emerging economy, Financial constraint, Financial cooperation, Real exchange rate, Sudden stop

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