# Financial Fragility and the Exchange Rate Regime*

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This Version: January 1998

**Abstract**

We study financial fragility, exchange rate crises and monetary policy in an open economy model in which banks are maturity transformers as in Diamond-Dybvig. The banking system, the exchange rate regime, and central bank credit policy are seen as parts of a mechanism intended to maximize social welfare; if the mechanism fails, banking crises and speculative attacks become possible. We compare currency boards, fixed rates, and flexible rates, with and without a lender of last resort. A currency board cannot implement a socially optimal allocation; in addition, under a currency board bank runs are possible. A fixed exchange rate system may implement the social optimum but is more prone to bank runs and exchange rate crises than a currency board. Larger capital inflows enhance welfare if the no-run equilibrium occurs, but may also render the economy more vulnerable to self-fulfilling runs. A flexible rate system implements the social optimum and eliminates runs, provided the exchange rate and central bank lending policies of the central bank are appropriately designed. *JEL Classification Numbers: F3, E5, G2. Key Words: exchange rates, currency crises, speculative attacks.*

*Velasco is grateful for support provided by the C.V. Starr Center for Applied Economics at NYU and the Harvard Institute for International Development. We are indebted to Guillermo Calvo, Allan Drazen, Javier Hamann, Robert Lawrence, Leonardo Leiderman, Mancur Olson, Arvind Panagariya, Carmen Reinhart, Will Roberds, Dani Rodrik, Jeffrey Sachs, Bruce Smith, Shang-jin Wei, Richard Zeckhauser, and seminar participants at the Atlanta Fed, Harvard University, University of Maryland, the World Bank, and the AEA Meetings for useful comments and suggestions. Of course, any errors are ours alone. The views expressed here are ours and not necessarily those of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

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