Exchange rate risks in a small open economy

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Abstract

This paper analyzes exchange rate risks and the choice of exchange rate policies in a small open economy indebted in foreign currency, incorporating the financial accelerator. As the result, we show that the currency peg for a foreign currency used in borrowing is more efficient than the trade-weighted currency basket policy, regardless of trade openness or trade share. The result implies that in the fear of floating discussions, we need pay more attention to exchange rate risks in finance and suggests that the exchange rate policy to defuse exchange rate risks in finance stabilizes macroeconomic volatilities more efficiently.

keywords : Fear of Floating, Currency mismatch, Exchange rate regime

JEL classification : F31; F33; F34; F41

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