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Abstract

Theory predicts that a fixed exchange rate regime will be abandoned after a sizable economic shock as currency devaluation serves to stimulate exports and output. This comes at the cost of higher inflation. While that prediction is generally consistent with reality, it also appears that many emerging markets resist devaluation despite substantial economic hardship. This paper proposes that the reluctance to devalue could stem from uncertainty about the control over inflation after devaluation. In countries with long-standing currency pegs as well as in countries where the fixed exchange rate was preceded by high inflation, central banks have little credibility. The uncertainty about the consequences of monetary policy raises the threshold of economic pain that could convince the policymakers to devalue. The paper develops this argument in a rules-vs-discretion theoretical framework. Empirical analyses based on survey data from Bulgaria support our hypothesis.