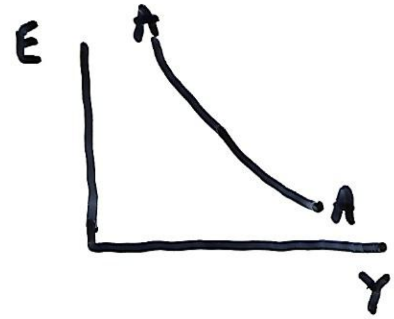
A 3rd-Generation Currency Crisis Model

- The previous 2nd-generation model focused on the potential role of multiple equilibria.
- However, the event of a currency crisis was in a sense irrelevant, since it did not influence output.
- In practice, currency crises often produce recessions.
- One reason is the presence of adverse "balance sheet effects"
- If firms have foreign currency debt, then a devaluation lowers their net worth. This constrains their ability to borrow + invest if investment must be collaterilized.
- 3rd-generation crisis models show how adverse balance sheet effects create potential multiple equilibria, and also explain why currency crises might cause severe recessions.
- The Asian Crisis of 1997-8 is the leading example.

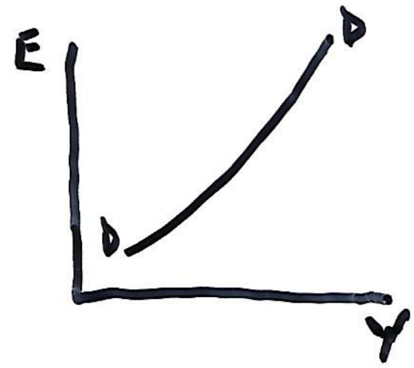
Quick Review of Econ 345

AA Curve: $R = R^* + \frac{E^e - E}{E}$

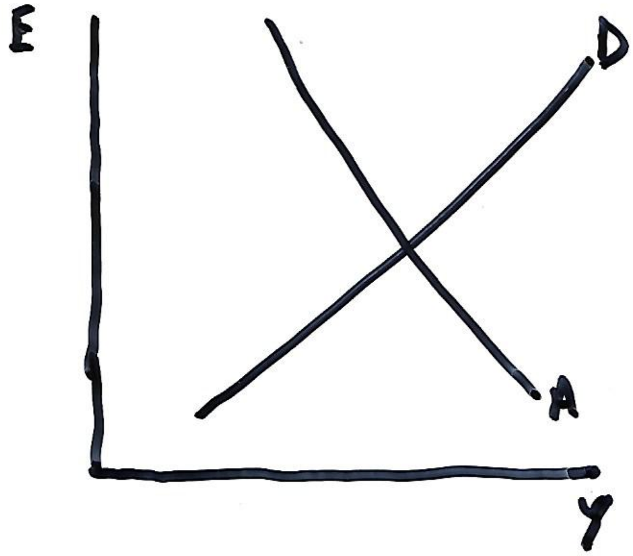
$M/P = L(\underset{+}{Y}, \underset{-}{R})$



DD Curve: $Y = D(\underset{+}{Y}, \underset{-}{R}) + NX(\underset{+}{\frac{EP^*}{P}}, \underset{-}{Y})$



Equilibrium



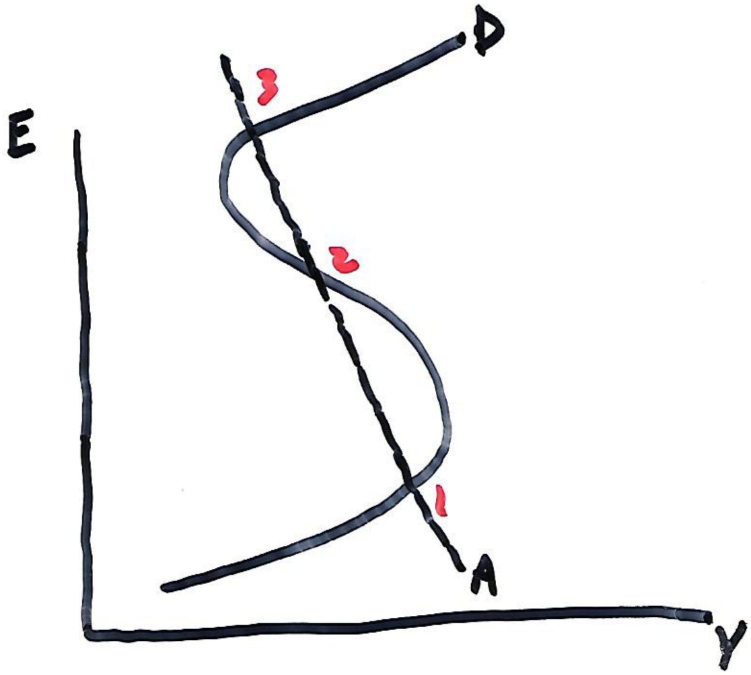
Equilibrium is unique if slopes are "monotonic"

- Now, what if there are adverse balance sheet effects?

- As $E\uparrow$, 2 offsetting effects:

  1.) $NX\uparrow$ [and $I\uparrow$ since $R\downarrow$ with E^e constant]

  2.) Net worth $\downarrow \Rightarrow I\downarrow$



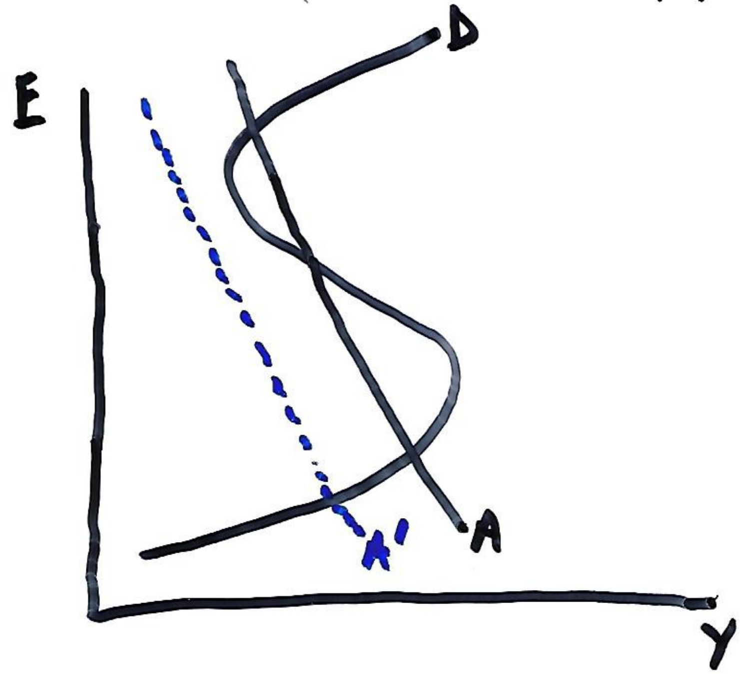
1, 3 : Stable Equil.

2 : Unstable Equil.

- Note, 3 is an inferior equilibrium. The corporate sector is bankrupt, and investment/output is low.

- Which equilibrium occurs? (Depends on expectations).

- Note, sufficiently contractionary monetary policy may eliminate the high E equilibrium, but only by creating an even worse recession!



- Better Policies:

   1.) Convince mkts. that E will not depreciate (IMF credit lines, Currency Boards, etc.)

   2.) Expansionary fiscal policy (Shift DD right)

   3.) Discourage foreign borrowing (flex. ex. rates?)