Emerging Market Crises

To organize one’s thoughts about emerging market crises, consider a semi-open economy, and the different situations it encounters. Many stories start with a boom, where capital is flowing in. Returning to IS-LM-BP=0:

B: Sterilize Inflows, A: No Sterilization, C: Allow Currency appreciation

D: Impose capital controls, \( \kappa \) decreases, so \( \frac{m}{\kappa} \) rises to \( \frac{m}{\kappa'} \)
Now consider the bust side of the situation. Suppose international investors expect the home currency to be devalued, or to depreciate in a discrete fashion:

Either US interest rates rise, or expected depreciation rises, or the risk premium rises. In this case, there is a balance of payments deterioration.

A: Allow outflow of money, no sterilization; B: Sterilize outflow; C: Allow depreciation; D: Reimpose capital controls