Public Affairs 854
Macroeconomic Policy and International Financial Regulation
Lecture 25
4/19/2021

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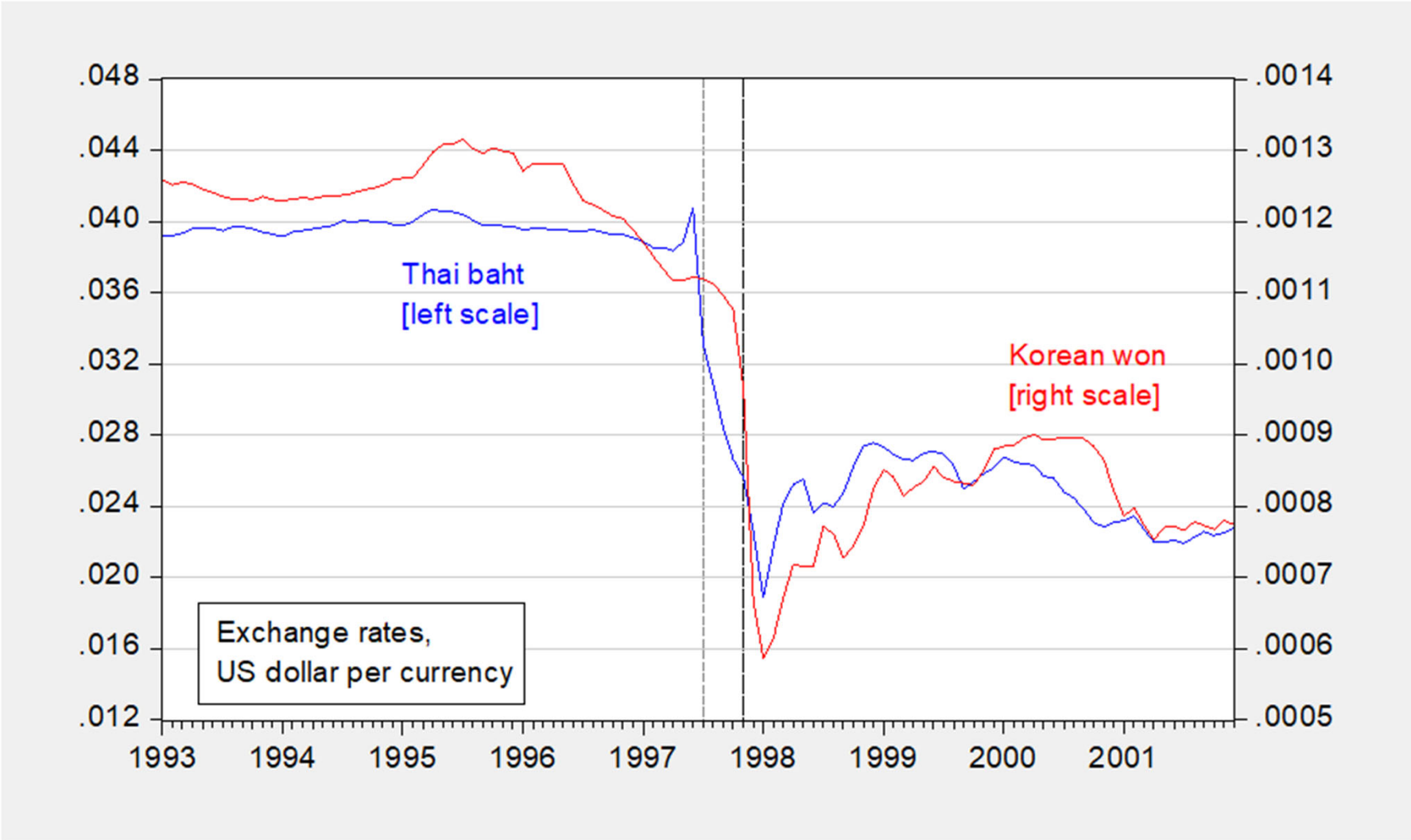
La Follette School of Public Affairs
Spring 2021

Outline

- Crises and Boom-Bust Cycles
- Managing Booms
- Managing Busts
- Contractionary Devaluation
- Balance Sheet Effects

Crises and Boom-Bust Cycles

Currency Crises of the 1990's



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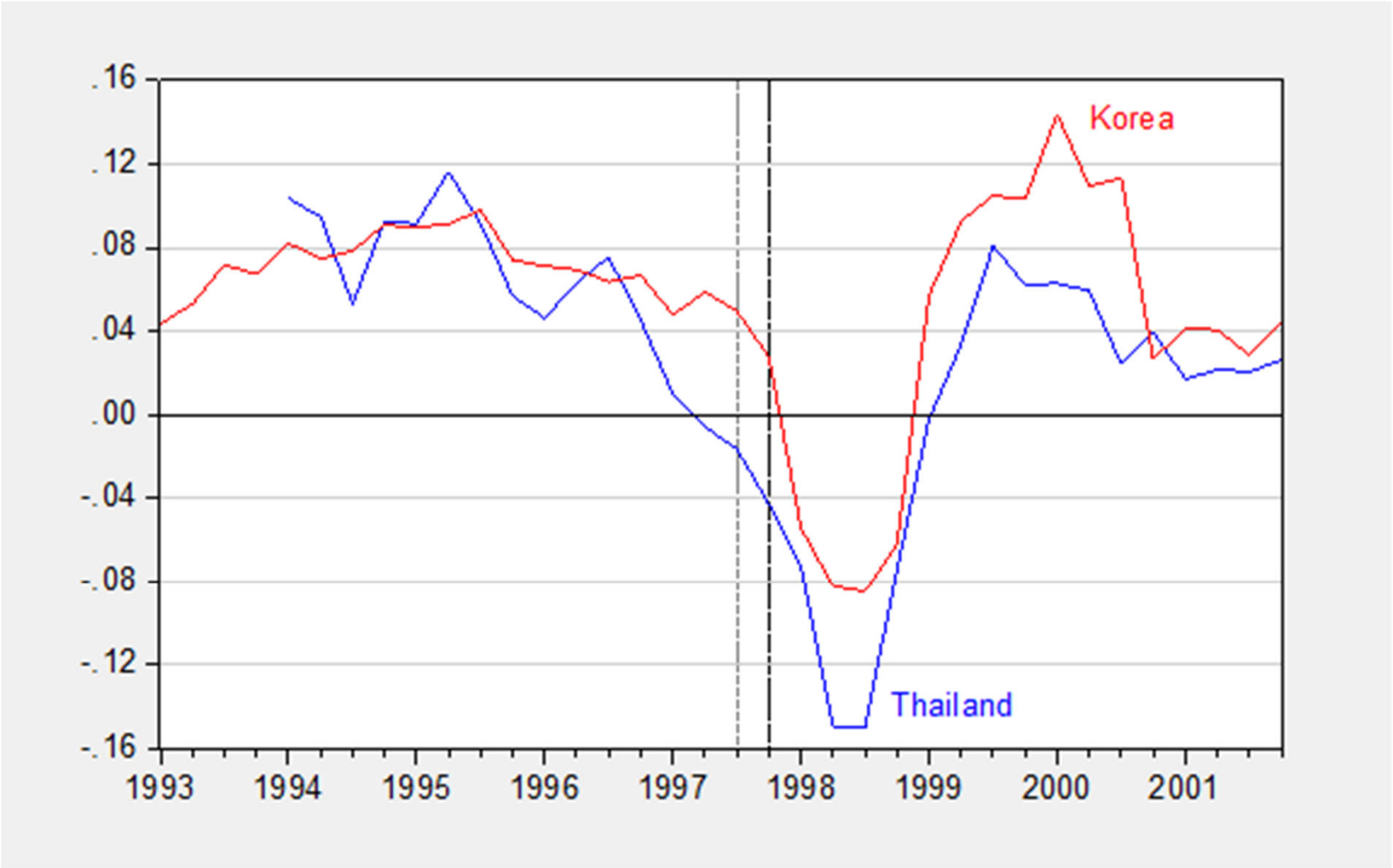
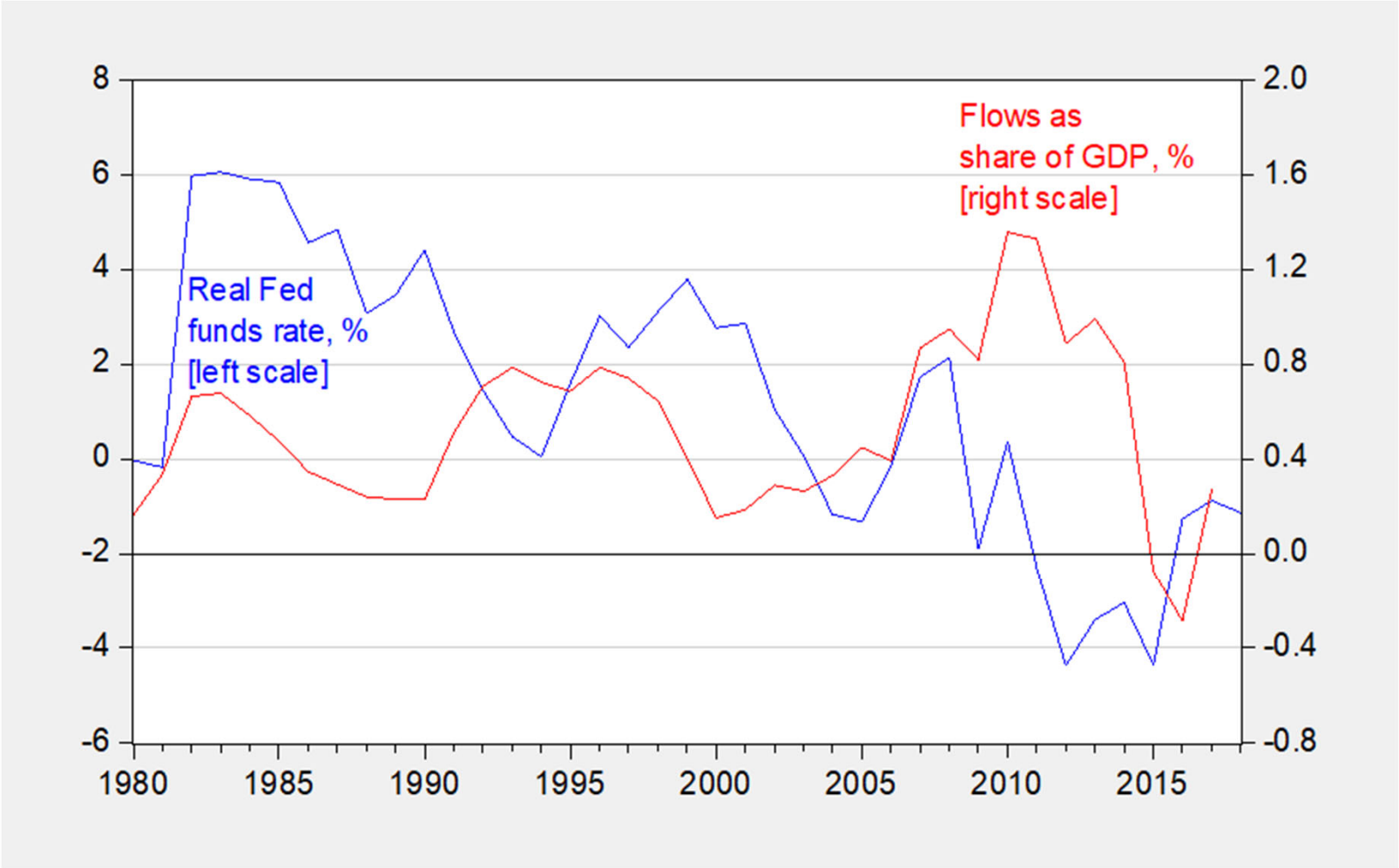


Surges & Reversals (of Financial Flows)



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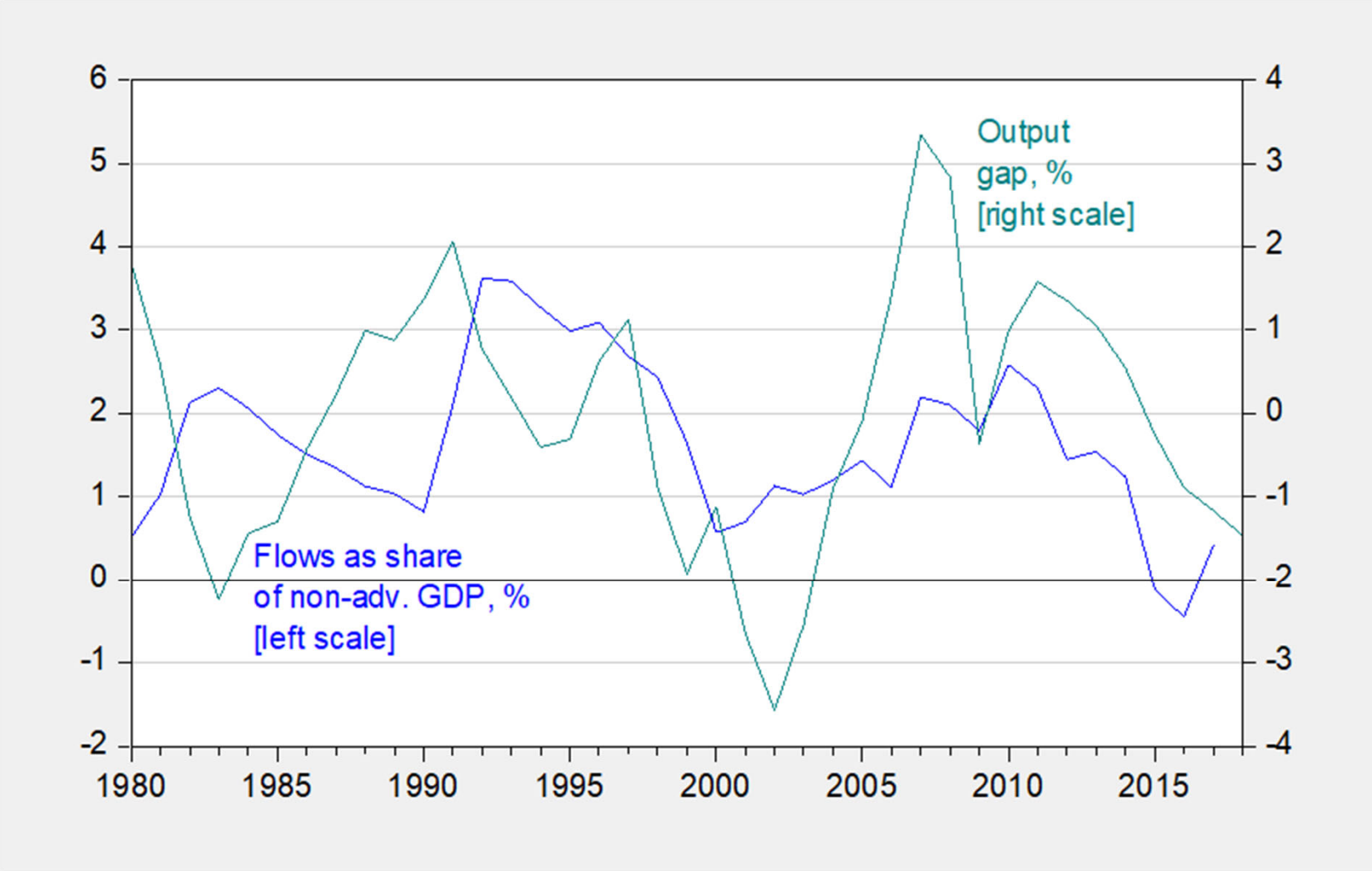
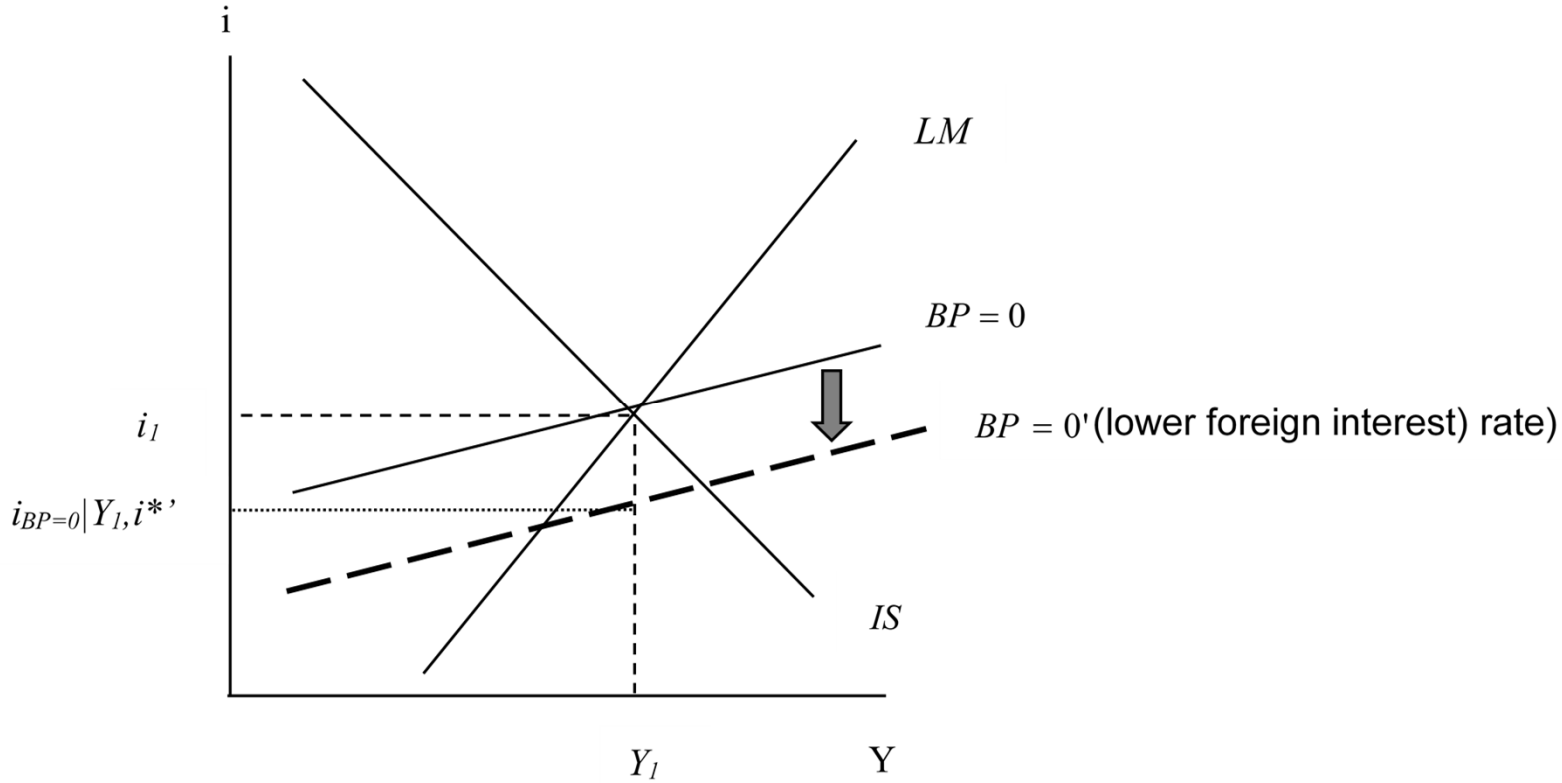


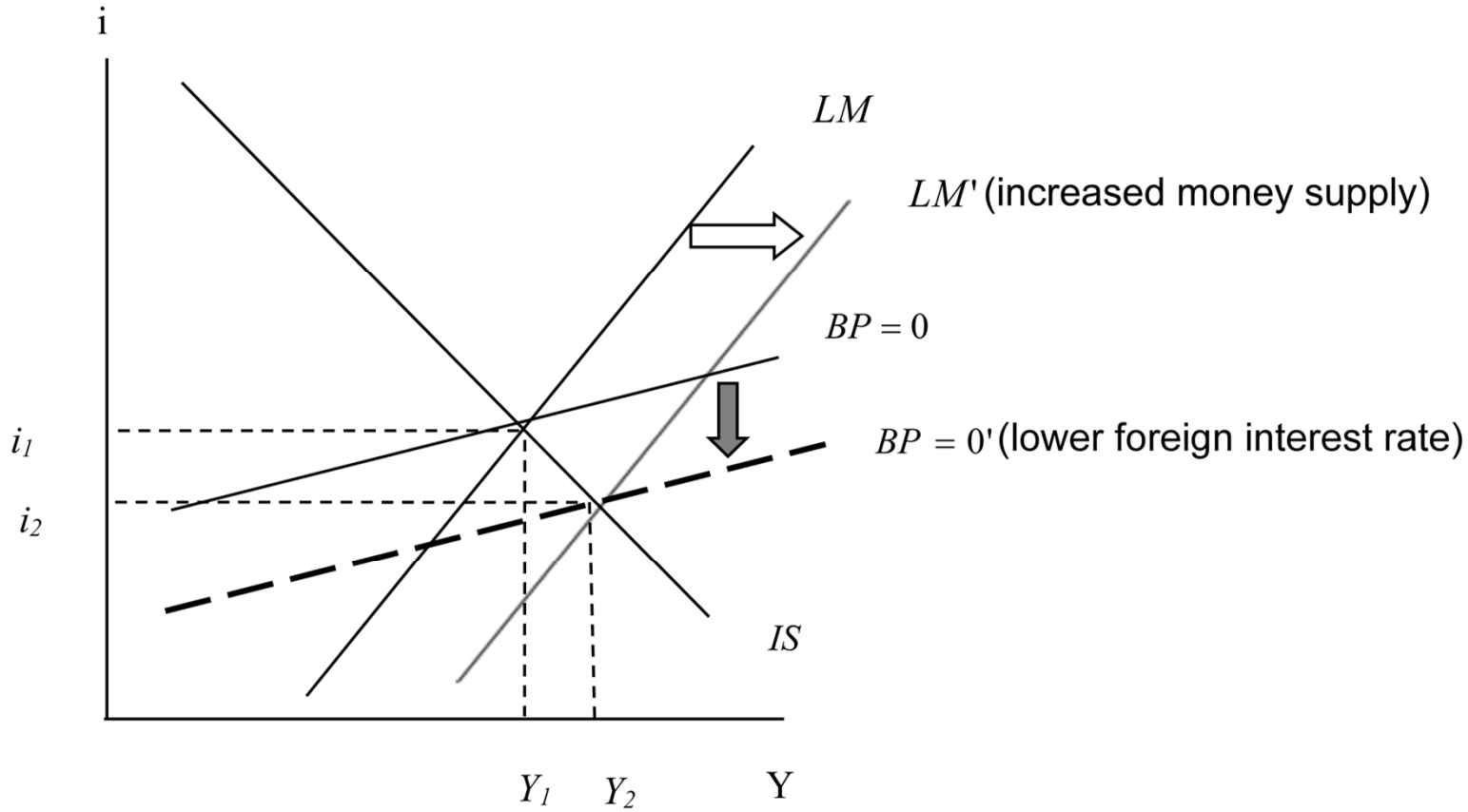
Managing Booms


i
LM
BP = 0
BP = 0' (lower foreign interest) rate)
i1
iBP=0|Y1,i*'
IS
Y1
Y

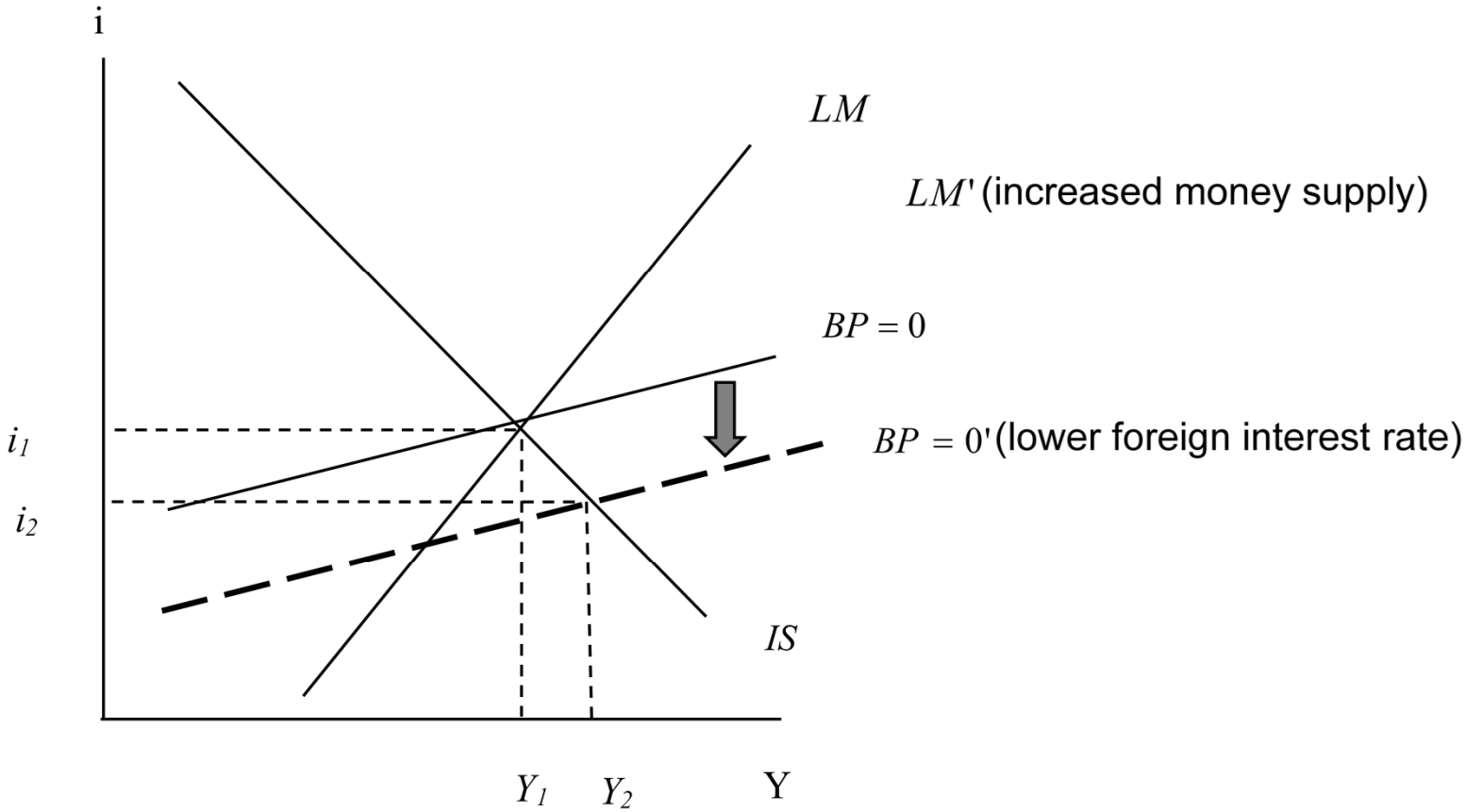
Options

- Accumulate foreign exchange reserves
- Sterilize the inflows
- Revalue the currency
- Impose capital controls

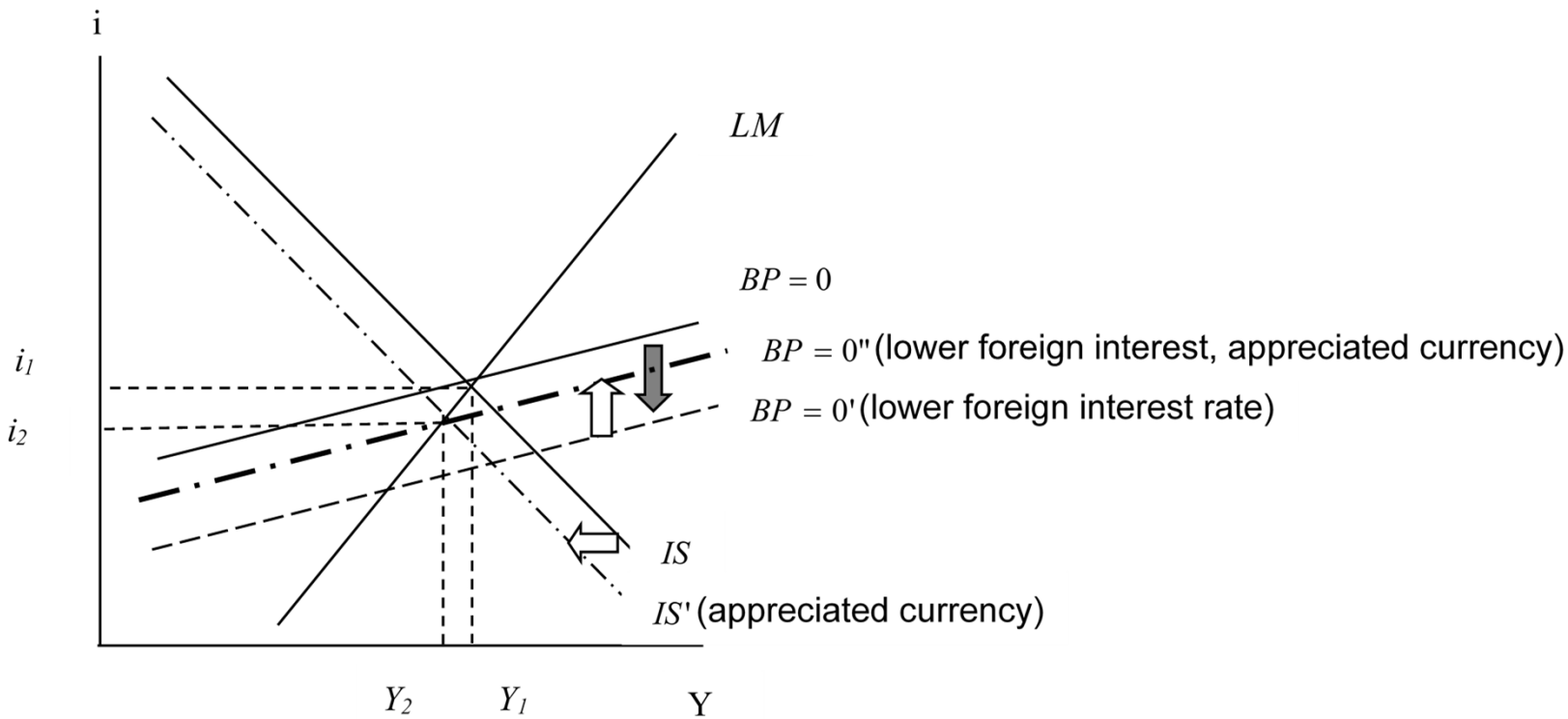
Accumulate FX Reserves, Don't Sterilize



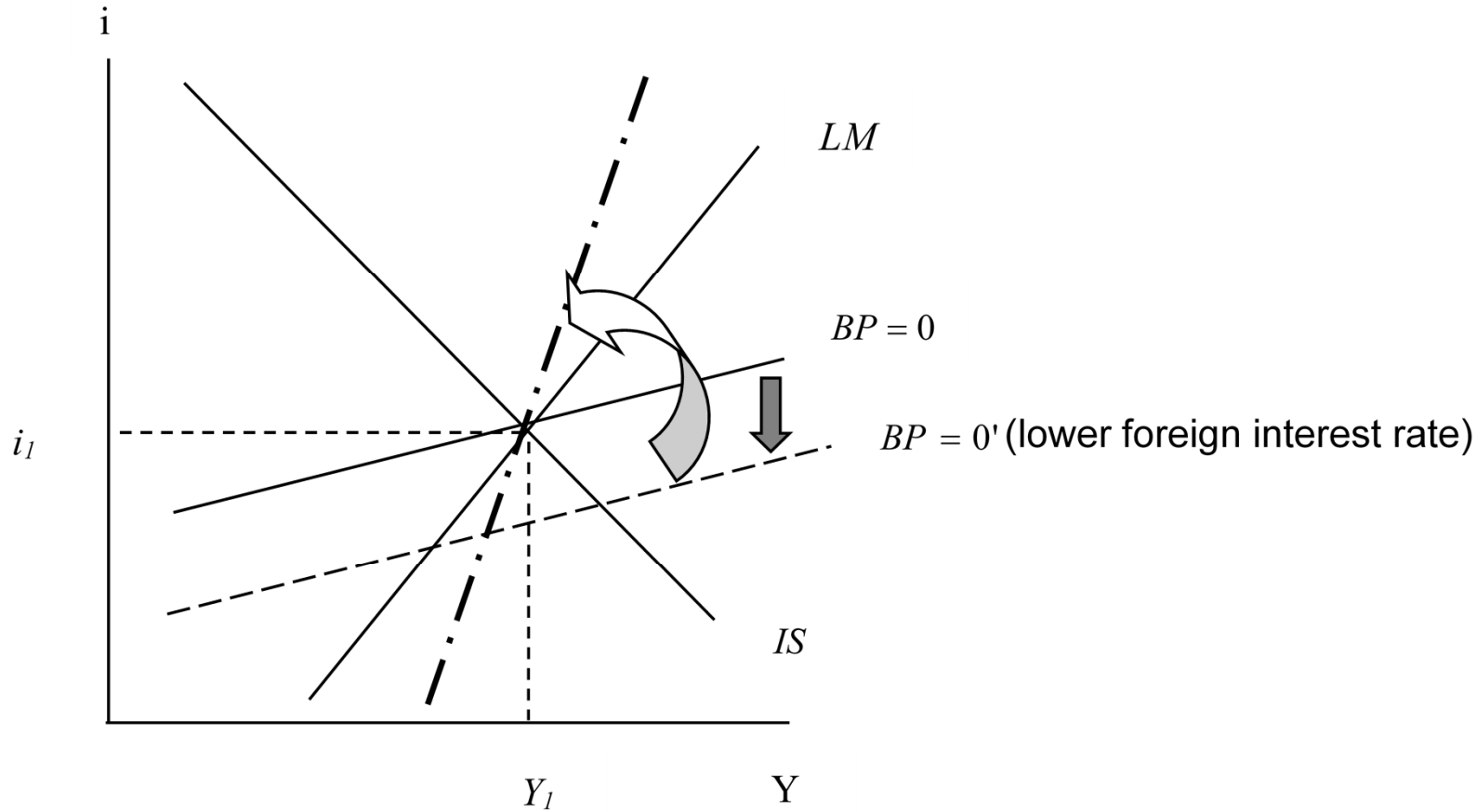
Sterilize Inflows



Revaluation



Capital Controls



Managing Busts

Including Risk in Mundell-Fleming

- Financial flows respond to risk

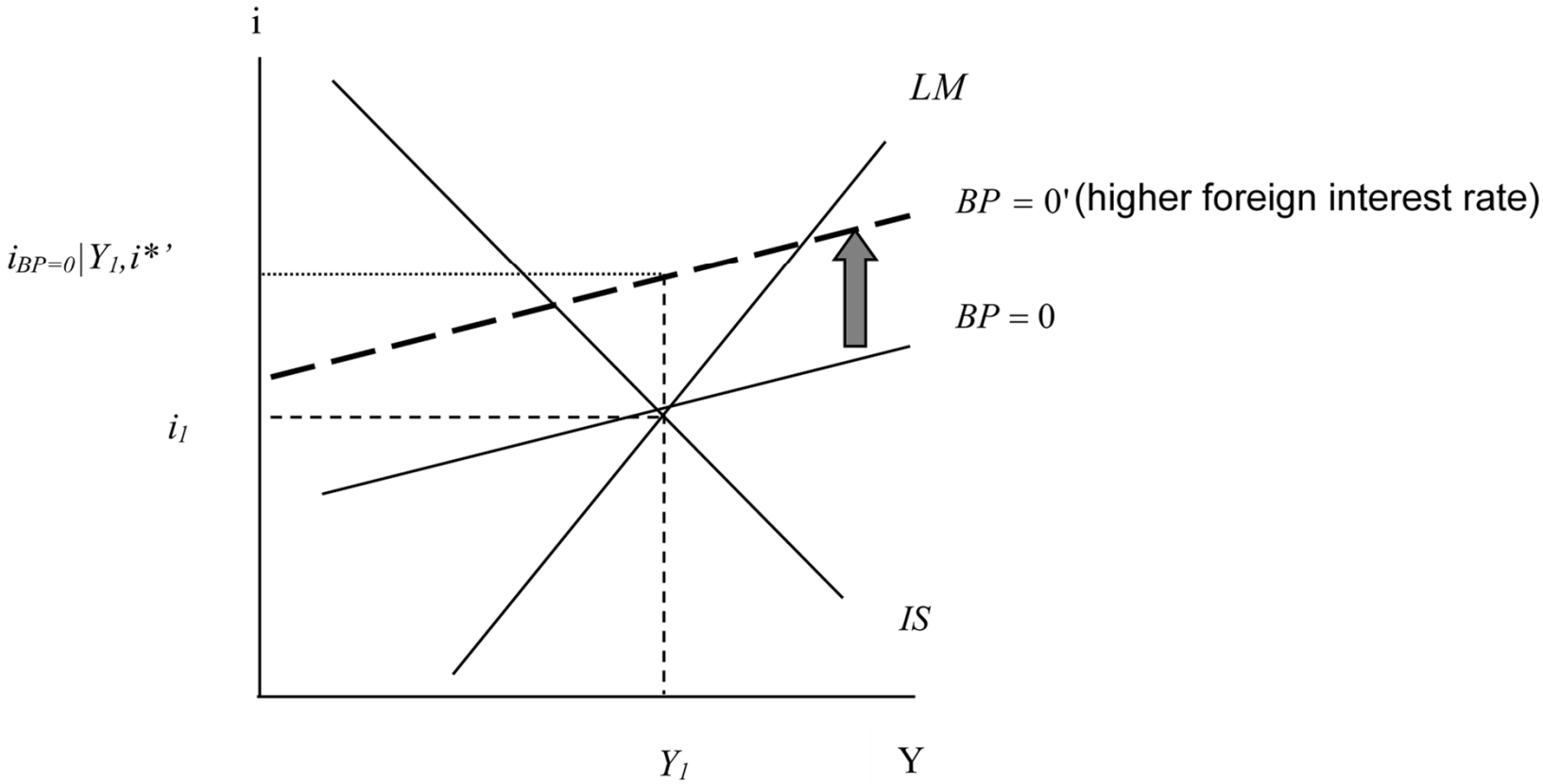
$$i = -\left(\frac{1}{\kappa}\right)[(\bar{X} - \overline{IM} + \overline{FA}) + (n + v)q] + \bar{\imath}^* + \left(\frac{m}{\kappa}\right)Y$$

$$FA = \overline{FA} + \kappa(i - \rho - \bar{\imath}^*)$$

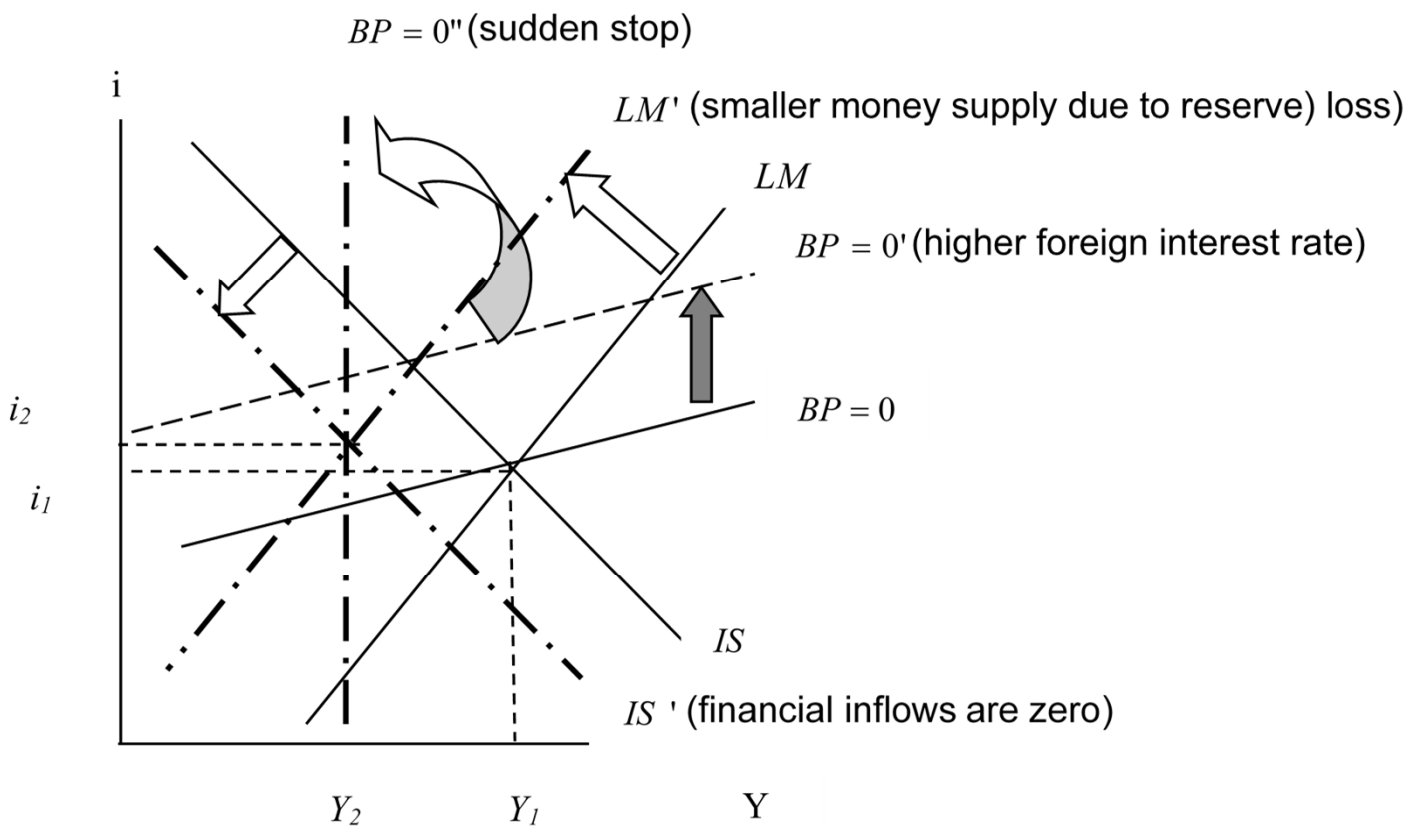
Risk premium on gov't bonds,
Due to possibility of default

$$i = -\left(\frac{1}{\kappa}\right)[(\bar{X} - \overline{IM} + \overline{FA}) + (n + v)q] + \rho + \bar{\imath}^* + \left(\frac{m}{\kappa}\right)Y$$

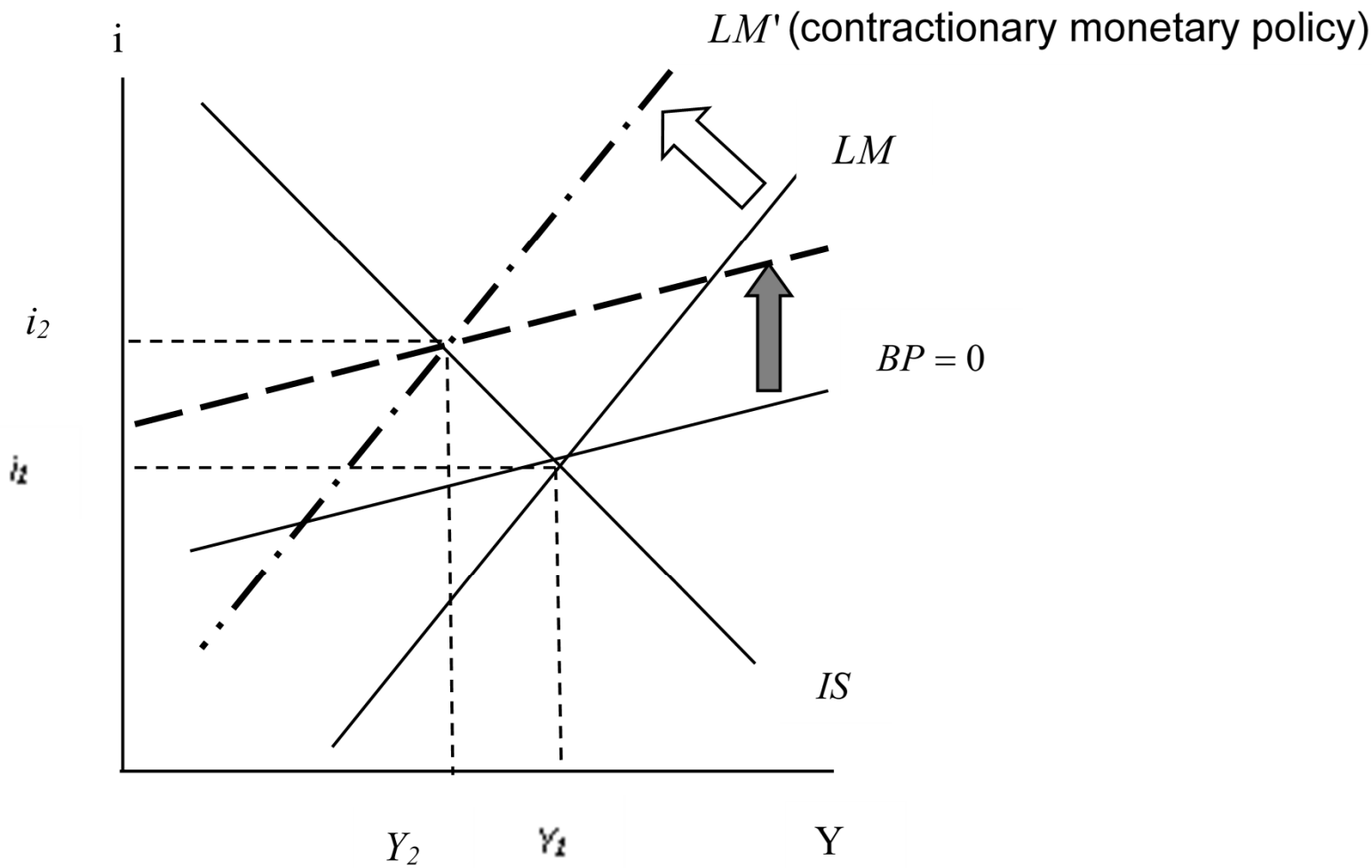
Rise in i^* or in ρ



Sudden Stop


$BP = 0''$ (sudden stop)
i
LM' (smaller money supply due to reserve) loss)
LM
$BP = 0'$ (higher foreign interest rate)
i_2
$BP = 0$
i_1
IS
IS' (financial inflows are zero)
Y_2
Y_1
Y

Responding to a BoP Crisis w/Tight Money

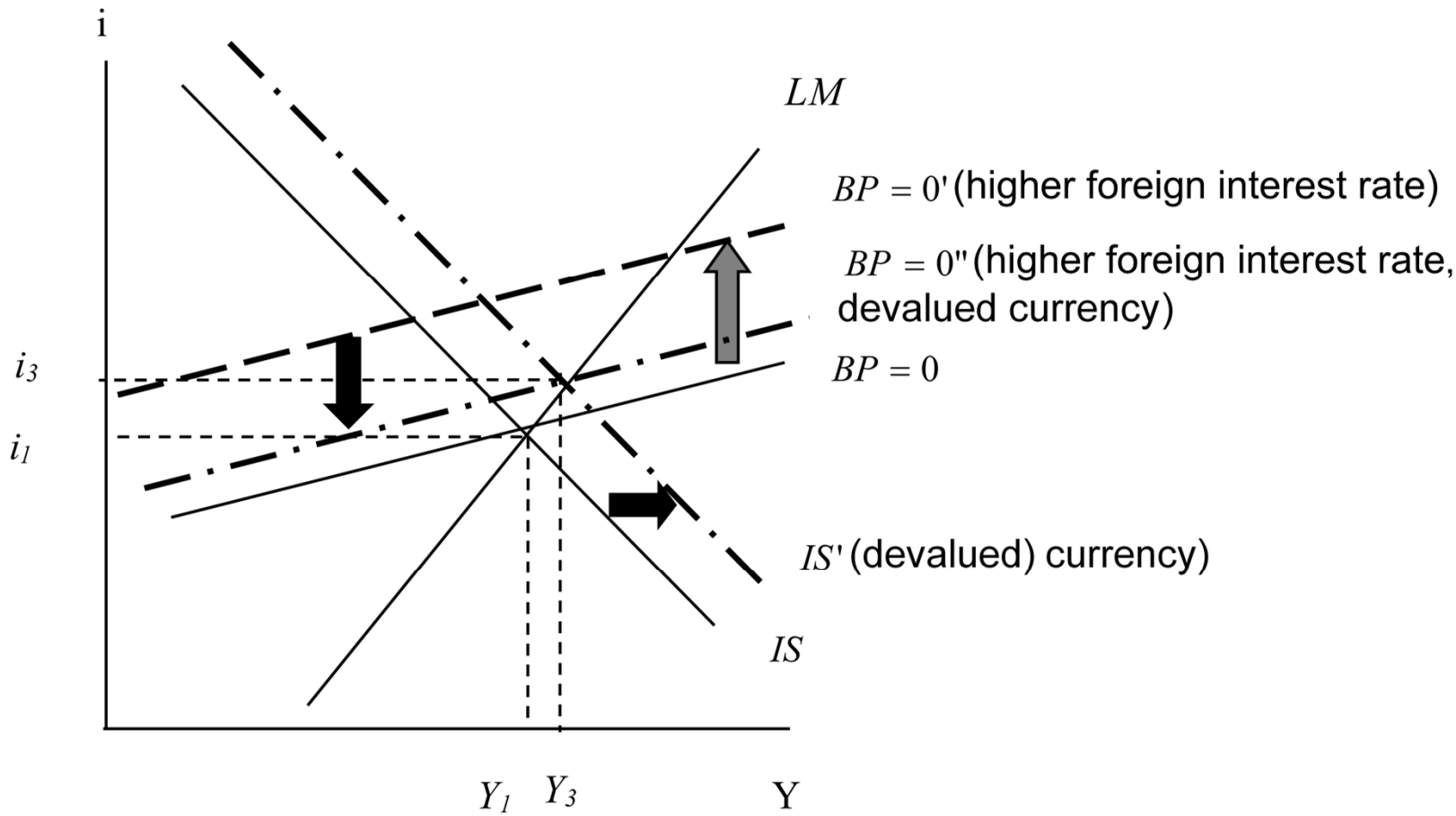


Contractionary Devaluation

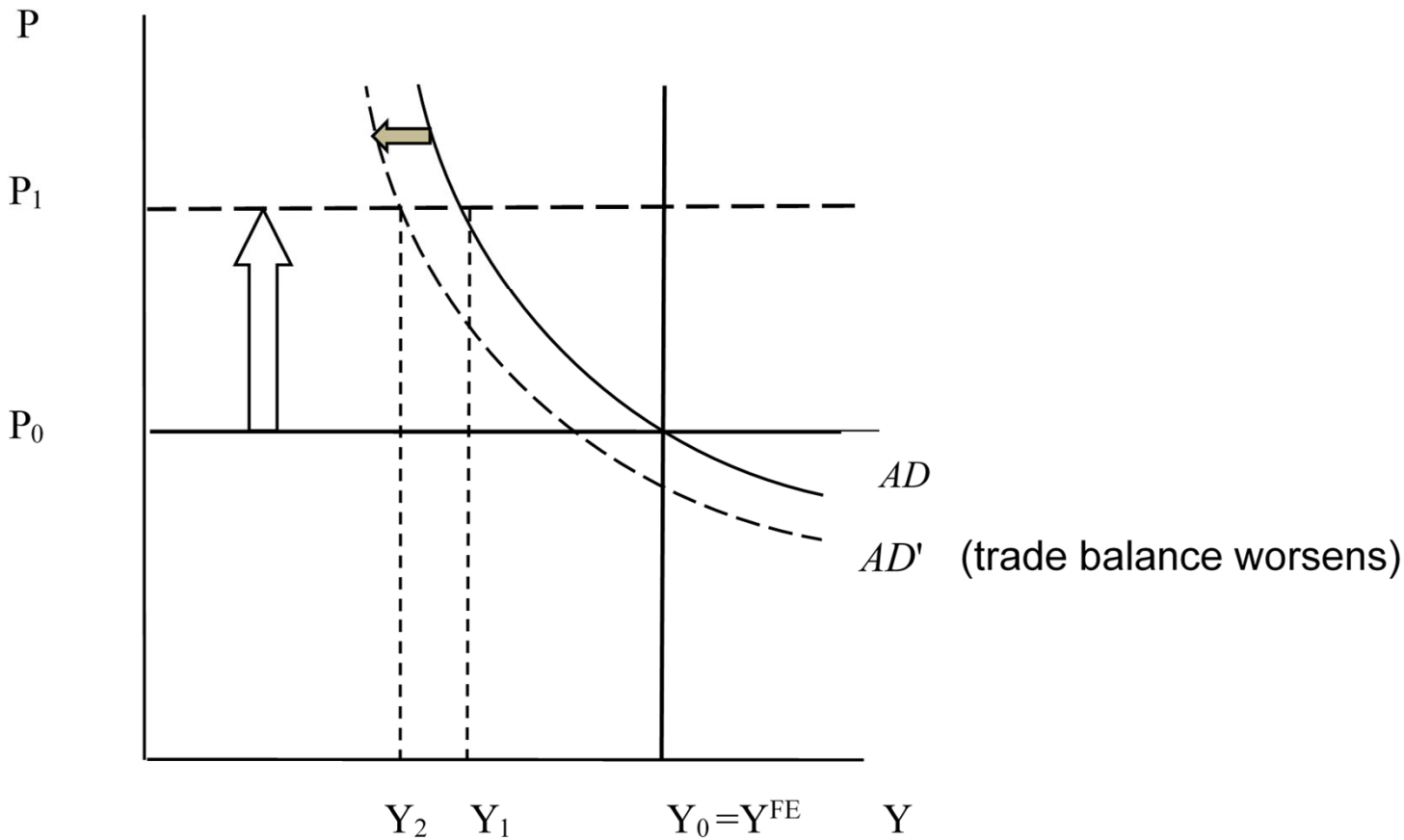
Why Might Devaluation be Contractionary?

- low trade elasticities in the short term,
- currency mismatch in balance sheets, and
- the inflationary impact on the price level

Low Trade Elasticities

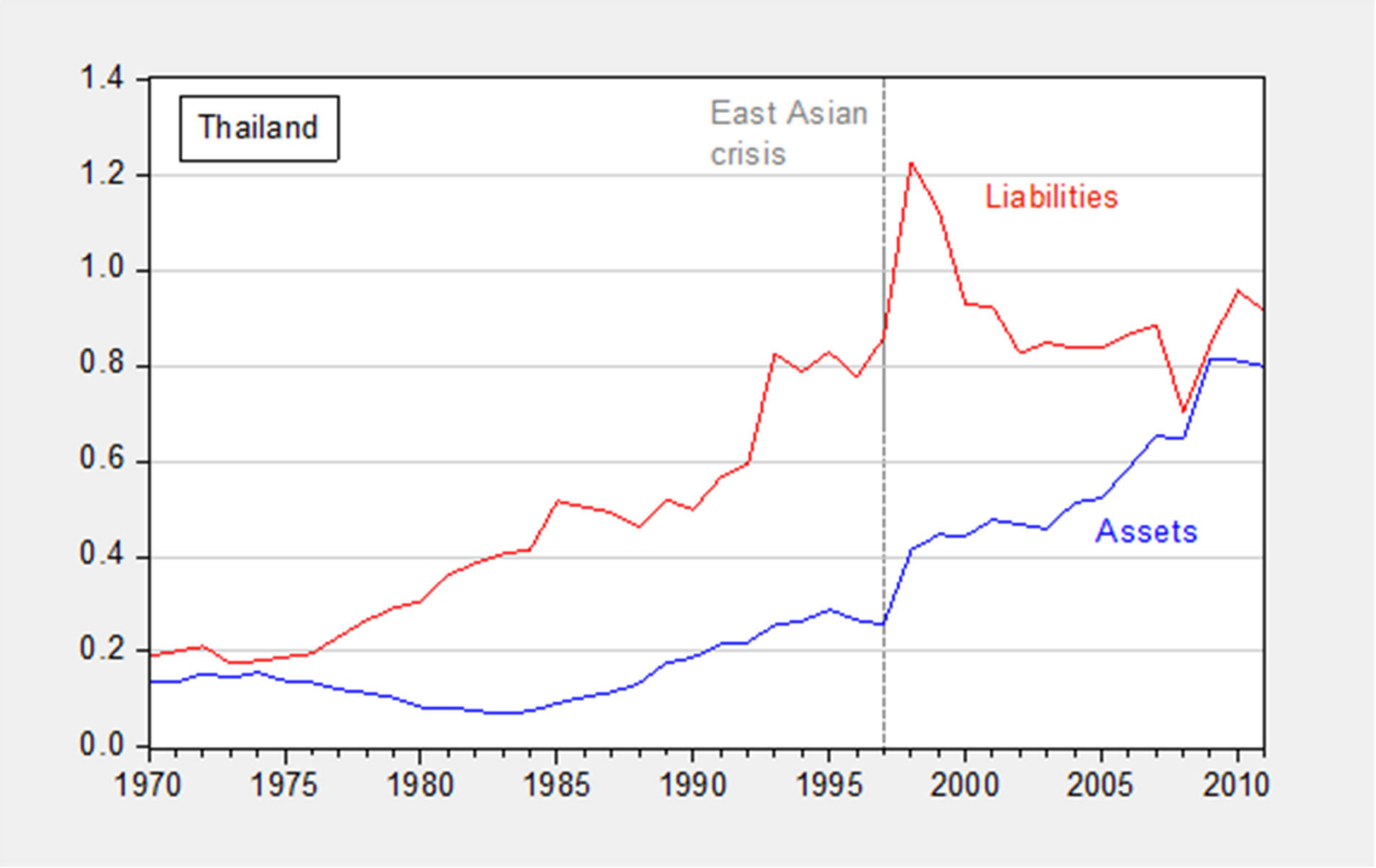


Higher Import Prices as Price Shock

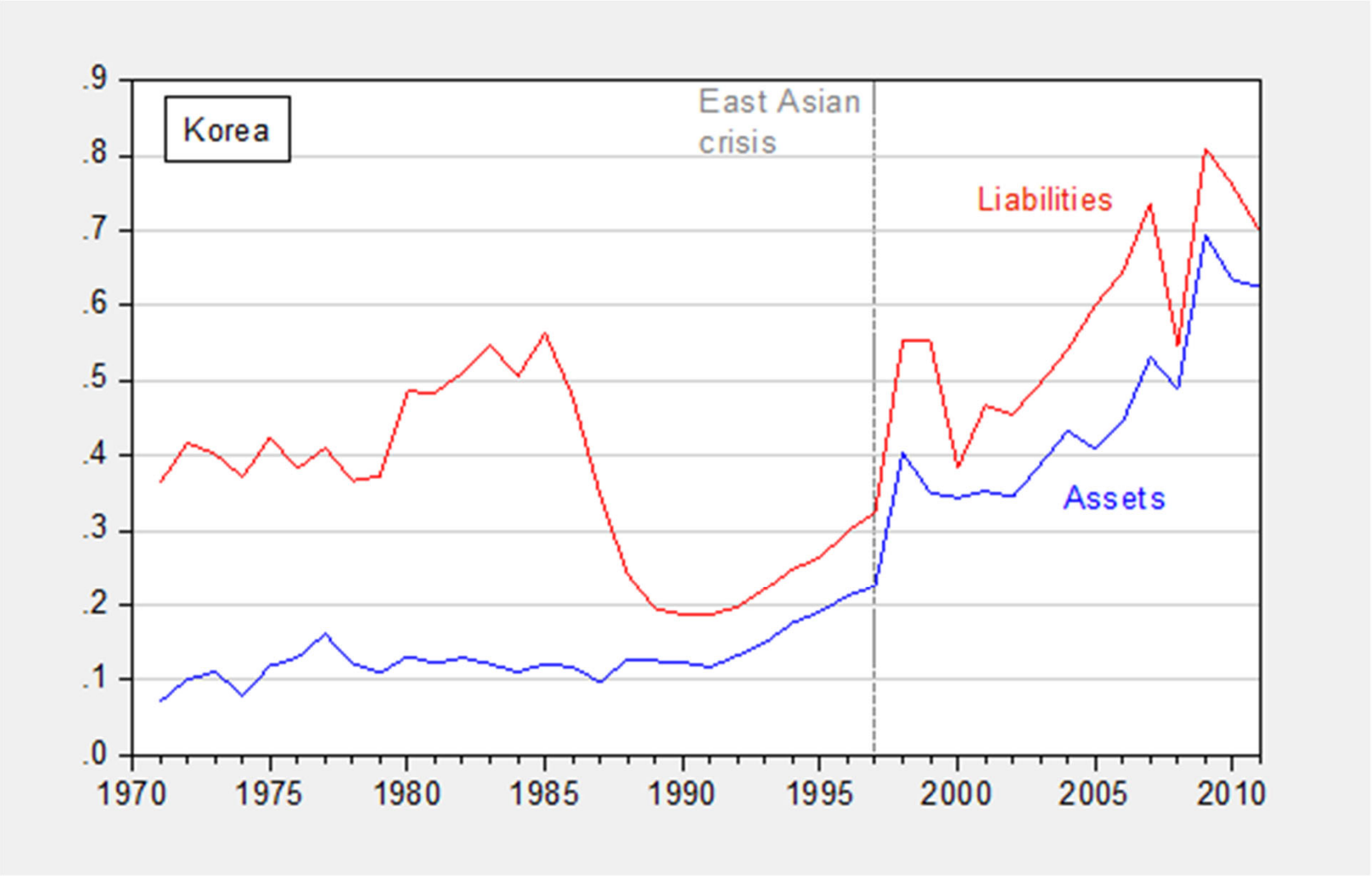


Balance Sheet Effects

Balance Sheets: Thailand



Balance Sheets: S. Korea



Mismatches

- By governments, banks, firms, households, country as a whole
- By maturity (short vs. long term), by currency (home vs. foreign), by capital structure, by solvency

Next Lecture

- Steven Kamin, to end-2020 Director, International Finance Division, Federal Reserve Board
- On spillovers from Fed policy, economic overheating, implications for emerging markets
- Bring questions!