Economics 161 — Spring 2004

Latin American Economic Development

# Review Sheet 3: Financial Crises and Policy Responses in Latin America

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## 1 Bond Values, Yields and Interest Rates

Suppose a 1 dollar bond with 1 year maturity has a 1 dollar face value and is trading at a 33 percent discount. What is the cost of the bond? The contracted interest rate is 8 percent. What is the yield on the bond?

## 2 Sovereign Risk, Debt Overhang and Moral Hazard

Explain why higher default risk increases the interest are. You may but need not provide a numerical example to illustrate your verbal explanation.

Explain in words the moral hazard problem associated with international debt service and default.

## 3 Debt Laffer Curve

Suppose Peru's market value of debt is equal to its average market value of debt. Would you recommend a debt buyback at the market price? Why or why not? For what set of countries would you recommend debt forgiveness? Why? You may but need not use the Debt Laffer curve to substantiate your verbal explanation.

# 4 Policy-Driven Currency Crisis

Suppose Uruguay maintains a fixed exchange rate. The Central Bank's balance sheet contains assets of 50 billion uruguayan pesos in domestic bonds and 50 billion uruguayan pesos in US 3-month Treasury bills. The Treasury Secretary would like to sell a 10 billion peso bond to the Central Bank.

1. For how long can the Central Bank monetize the government's debt while maintaining a fixed exchange rate?
2. Why might a currency crisis erupt?
3. What are the effects of debt monetization under a floating exchange rate regime?

# 5 Policy Trilemma

Ecuador pursues a policy of full dollarization. Chile enacted controls on the inflow of foreign capital. Mexico maintains free floating exchange rates and full capital mobility.

1. Describe the policy trilemma.
2. For each of the countries above, which two objectives did the country choose and which did it sacrifice?
3. Choose a Latin American country of your choice and discuss the policy trilemma, using the country of your choice as an example.
4. What are the benefits of choosing a policy like Mexico's versus Ecuador's? What are the costs?