

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

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Instructor: Marc-Andreas Muendler
E-mail: muendler@ucsd.edu

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 contractual interest rate is 8 percent. What is the effective nominal yield on the bond?

What is the real yield on the bond for a domestic resident who cares only about domestic inflation? What is the real yield on the bond for a foreign resident who only cares about exchange rate depreciation (devaluation)? Does domestic monetary policy affect real returns for domestic and foreign investors in the same way?

2 Sovereign Risk

Explain why higher default risk increases the interest rate. Provide a numerical example to illustrate your verbal explanation.

Explain in words the moral hazard problem associated with international debt service and default. Distinguish between ability and willingness to repay and explain two scenarios under which lacking willingness to repay can be concealed as lacking ability.

3 Debt Laffer Curve

Peru's market price of debt is equal to the average market value, and below face value. 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? Use the Debt Laffer curve to substantiate your verbal explanation.

4 Policy Trilemma

Ecuador pursues a policy of full dollarization. Chile enacted controls on the inflow of foreign capital in the early 1990s. Mexico permits its exchange rate to float and maintains international capital mobility.

Describe the policy trilemma. For each of the countries above, which two objectives did the country choose and which did it sacrifice? What are the benefits of choosing a policy like Mexico's versus Ecuador's? What are the costs?