Economics 161 — Fall 2005

International Integration of Latin American Economies

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

Peru's market prize 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? You may but need not 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?