A Simple Model of Monetary Policy and Currency Crises

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Abstract

This paper analyzes the optimal interest rate policy in currency crises. Firms are credit constrained and have debt in domestic and foreign currency, a situation that may easily lead to a currency crisis. An interest rate increase has an ambiguous effect on firms since it both makes more difficult to borrow and may decrease the foreign currency debt burden. In some cases it is actually best to *decrease* the interest rate. We also show how these issues are related to the development of the financial system.

1 Introduction

The recent currency crises have underlined the trade-offs that central banks face when designing appropriate monetary policies for dealing with such crises. In particular, central banks in some Asian and Latin American countries have run into strong criticisms for having raised nominal interest rates