

Financial Crises in Emerging Markets: A Canonical Model*

Roberto Chang[†]
Federal Reserve Bank of Atlanta

Andrés Velasco[‡]
NYU and NBER

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Abstract

We present a simple model that can account for the main features of recent financial crises in emerging markets. The international illiquidity of the domestic financial system is at the center of the problem. Illiquid banks are a necessary and a sufficient condition for financial crises to occur. Domestic financial liberalization and capital flows from abroad (especially if short term) can aggravate the illiquidity of banks and increase their vulnerability to exogenous shocks and shifts in expectations. A bank collapse multiplies the harmful effects of an initial shock, as a credit squeeze and costly liquidation of investment projects cause real output drops and collapses in asset prices. Under fixed exchange rates, a run on banks becomes a run on the currency if the Central Bank attempts to act as a lender of last resort. *JEL Classification Numbers: F3, E5, G2. Key Words: currency crises, bank runs, monetary policy.*

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[†]Telephone: (404) 521-8057. Email: roberto.chang@atl.frb.org

[‡]Telephone: (212) 998-8958. Email: andres.velasco@econ.nyu.edu