



Fiscal imbalances and the dynamics of currency crises

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Abstract

This paper analyzes links between the fiscal theory of the price level (FTPL) and the first generation models after Krugman (Journal of Money Credit and Banking 11 (1979), 311–325), exploring the idea that a synthesis between the two can become a new framework to analyze the fiscal dimension of currency crises. Working in a simple synthetic framework, we show how external nominal shocks can cause a fiscal imbalance and undermine currency stability, resolve two well-known paradoxes of the first generation model, discuss the role of seigniorage revenues, and illustrate how fiscal and interest rate policies interact to determine the magnitude and the timing of speculative attacks and devaluations.

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1. Introduction

In his macroeconomic lectures at Yale, Christopher Sims often remarked that the “first generation mode” of currency crises due to Krugman (1979) and the fiscal theory of the price level (FTPL)¹ were “close cousins”. In this paper, we explore formally links between the FTPL and the Krugman model.² We specify a simple, tractable model that we see as a step toward a more general, synthetic model of fiscal imbalances and currency crises. Our analysis yields a number of new results and clarifies some aspects of the literature.

Although the Krugman model appeals informally to fiscal considerations, a currency crisis arises in that model exclusively as a consequence of domestic credit creation by the central bank. A strength of the Krugman model was its simplicity, but the model proved difficult to reconcile with evidence from recent currency crises. The observation that the currency crises in East Asia were not preceded by domestic credit expansion was a factor that motivated the first recent extension of the Krugman model. In Corsetti et al. (1999), a currency crisis is caused by *anticipated future* growth in domestic credit. Soon it became apparent that this extension per se would be insufficient to make the first generation model consistent with the recent crises. Burnside et al. (2001, 2003a,b), henceforth BER, documented that while the devaluations in Latin America, East Asia and Turkey were associated with large fiscal imbalances, governments financed only moderate fractions of the imbalances with seigniorage revenues. A decrease in the real value of nominal government liabilities played a quantitatively more important role than seigniorage revenues. In an effort to match the evidence BER extended the first generation model, including in it nominal government liabilities (such as domestic-currency debt and spending commitments not indexed to the exchange rate).

Daniel (1998, 2001a) applies more directly than BER two insights from the FTPL in a model of currency crises. Given a fiscal imbalance, the government budget constraint *seen as an equilibrium condition* implies that the price level increases and the exchange rate depreciates. The FTPL highlights the role of maturity of public debt in macroeconomic dynamics: Long-term nominal debt smooths out the effects of fiscal shocks on the equilibrium price level (Cochrane, 2001; Woodford, 1998). In Daniel’s work long-term nominal debt helps delay devaluation, consistent with the FTPL.

The contributions of Corsetti, Pesenti and Roubini, BER and Daniel are sometimes seen as an alternative to the Krugman model. In light of Sims’s remark, however, we see them as steps toward a new, synthetic model of fiscal imbalances and currency crises that will combine the insights of Krugman with those of the FTPL. In this paper, we take a further step towards building such a synthetic model.

Our starting point is the intuitive experiment of Krugman. We assume a fixed exchange rate and postulate an exogenous shock that decreases the present value of

¹For example Benhabib et al. (2001), Leeper (1991), Sims (1994) and Woodford (1995).

²See Corsetti and Maćkowiak (2000) and Daniel (1998, 2001a).

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