Interest Premium, Sudden Stop, and Adjustment in a Small Open Economy

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Abstract

We study the adjustment process of a small open economy to a sudden worsening of external conditions. We build a two-sector model with money-in-the-utility, which allows us to study the role of currency mismatch. Our main contribution is the specification of the endogenous external finance premium: we use a highly non-linear specification that captures credit constraint in a convenient way. The advantage of our approach is that the effects of the shock become highly conditional on the external debt position of the economy. We calibrate the model to the behavior of the Hungarian economy in the 2000s and its crisis experience in 2008 in particular. We also calculate three counterfactuals: one with smaller initial indebtedness, and two with different exchange rate policies (free float and a perfect peg). Overall, our model is able to fit key macroeconomic variables after the crisis reasonably well, and offers a meaningful quantification of the tradeoff between boosting exports by letting the currency depreciate and protecting consumption expenditures by limiting adverse exchange rate movements.

Keywords: interest premium, sudden stop, small open economy.

JEL Codes: E21, E41, E5, F3

1 Introduction

The "crisis of 2008" is the biggest and most widespread recession since the Great Depression. While the crisis originated in the United States, it quickly spread to other advanced and emerging economies. Although in the US the main problem was the near collapse of financial intermediation, in many small emerging economies the key feature of the recession was a sudden worsening of external credit conditions. Taking such a shift in the external financing premium as given, our goal is to study the effects of such

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an exogenous shock using a two-sector small open economy model. Our main contribution to the large literature on this topic is a novel specification of the external finance premium, which leads to a strong international transmission of shocks through financial markets (like in Devereux and Yetman, 2010), and resembles more complex frameworks of occasionally binding credit constraints (like Mendoza, 2010) in three important aspects: (i) near-constant interest rate on assets, (ii) quickly rising premium for large debt holdings, and (iii) (almost) existence of an absolute borrowing constraint. This allows us to study the effects of the crisis conditional on the external debt position of our model economy.

We then link the impact of the external financing shock to the exchange rate regime of the country. Existing models (for example, Gertler, Gilchrist and Natalucci, 2007, or Faia, 2010) usually quantify the welfare costs of the constraint that a pegged regime puts on the response of an economy to such a shock: on the one hand, flexible exchange rates allow a quicker nominal adjustment in case of nominal frictions (price or wage stickiness); and on the other hand, in order to defend the exchange rate, the central bank has to raise interest rates, which – through financial frictions – exacerbates the initial output loss. In case of domestic (or a mix of domestic and foreign) shocks, however, Faia (2010) finds that a peg can allow a softer reaction of the interest rate, hence a smaller output response.

We, on the other hand, want to explore the following advantage of a pegged (or managed float) regime in response to an increase in the external premium. Emerging economies, and countries in Central and Eastern Europe in particular, have built up significant unhedged foreign currency liabilities before the 2008 crisis (currency mismatch). The sudden tightening of their borrowing terms has put their nominal exchange rates under pressure, and the resulting depreciation severely weakened the balance sheets (foreign currency value of net wealth) of almost all economic actors (households, firms and the government) in these countries, amplifying the impact of the crisis. Most of their central banks were defending their exchange rates both by interest rates and interventions, in order to limit the deterioration of balance sheets. We are focusing on the role of reserves, as they allow the central bank to manage exchange rates with smaller domestic interest rate hikes.

More precisely, we seek answers to the following questions. What is the effect of an unexpected, significant tightening of foreign borrowing conditions on the convergence path of a small open economy? How does the effect depend on the external debt position of this economy? Can the central bank alleviate the real effects by manipulating the nominal exchange rate?

To answer these questions, we build a quantitative two-sector small open economy model with endogenous currency mismatch through foreign currency borrowing and money in the utility. The role of the latter is to provide a (reduced form) rational for households to hold domestic currency denominated assets. We assume that foreign borrowing has to be in foreign currency, and the interest rate is dependent on the indebtedness of the economy. The main shock we are interested in is a permanent tightening of
external credit conditions, implemented as a rise in the foreign interest premium. An important method-
ological contribution of our paper is that we work in a deterministic framework, and hence we are able
to solve the model nonlinearly. This allows us to use a highly nonlinear and asymmetric specification for
the interest premium function.

Our motivation comes from the crisis experience of Hungary and other countries in the Central and
Eastern European (CEE) region. In order to match the initial developments in these countries, we add
a second, one period shock that captures the large drop in foreign demand. While this may ultimately
be caused by the same world-wide tightening of credit conditions, in our small open economy setting it
is simpler to implement it as a decline in foreign demand.

We describe the model in detail later, but the main intuition is as follows. The increase in the interest
premium makes households poorer, and its also makes foreign debt more costly. Households respond by
paying back debt through reducing consumption, working more, and decreasing their money demand. In
response to the decrease in export demand, employment in the export sector decreases, while households
borrow more to smooth consumption and work less due to lower labor demand and hence lower wages.
The net effect in the short run depends on the strength of these often opposing effects.

Depending on the exchange rate regime, the money market clears in different ways, which has im-
portant implications for the real economy. When the exchange rate is flexible, it depreciates to match
the fixed nominal supply of money to the reduced demand. The lower exchange rate, in turn, stimulates
exports, and dampens the effect of the export demand shock. Consumption falls, however, since the lower
exchange rate increases the indebtedness of the economy measured in foreign currency (tradables).

When the exchange rate is fixed, the export sector cannot take advantage of a weaker currency, hence
exports and employment fall more. Households, on the other hand, can use their money holdings to pay
back foreign debt at the fixed exchange rate, and hence their balance sheet remains in a better shape.
This, in turn, implies that consumption declines less than under a flexible exchange rate. One of our
main goals is to quantitatively evaluate the tradeoffs between export performance, currency mismatch,
and the exchange rate regime.

There are many other studies that employ quantitative small open economy models to understand
the effects of various external shocks. Fernandez de Cordoba and Kehoe (2000), and Bems and Hartelius
(2006) use a two-sector real model to study the current account and real exchange rate implications of
a nominal side by introducing money. Apart from the different question (Rebelo and Végh (1995) look at
exchange rate based stabilizations, while Burstein, Eichenbaum and Rebelo (2007) study exchange rate
pass-through under large devaluations), our model differs in several aspects. In our framework, money
does not have a direct role through a transaction technology, a feature both of their models exhibit.
Burstein, Eichenbaum and Rebelo (2007) also assume price rigidity, while we have totally flexible prices. Even more importantly, our model has an external interest premium, so it can be used to analyze the role of credit conditions. Finally, Cook and Devereux (2006) and Gertler, Gilchrist and Natalucci (2007) both have financing frictions, but they do not consider the implications of a currency mismatch in external positions.

Our model builds directly on Benczur and Konya (2011). In that paper, however, the main goal is to understand the impact of the exchange rate regime on capital accumulation in a transition economy. Here, on the other hand, we look at countries that experience external shocks and move from one steady state to the next. We also modify the Benczur and Konya (2011) model in three aspects. (i) We add a downward sloping export demand curve, which allows us to add an export demand shock. (ii) We introduce a monetary policy rule that accommodates interim exchange rate regimes (“dirty floating”, as opposed to a pure float or a fixed exchange rate regime). (iii) And finally, we assume that the external premium depends on the net foreign asset position of households, instead of the consolidated position of the country itself (which would also include central bank reserves). This assumption exacerbates the impact of the currency mismatch. Note that while a depreciation in general leads to a capital loss of households, it also implies a nearly offsetting capital gain at the central bank. But due to our external premium specification, even if this gain is redistributed to households, there is still a worsening in the external premium.

Once we described our model economy, we calibrate the model to fit important aspects of the Hungarian economy. Then we introduce the shock of 2008 by an export demand shock and a change in the parameters of the external premium function (a large decline in the neutral level of the net foreign asset position), fitting exchange rate, interest rate and employment changes. Overall, we judge the model’s ability to fit key macroeconomic variables to be very good: all variables move in the expected direction, and the magnitudes are also reasonable.

Then we do three counterfactual experiments, which give us the following results. (i) Lower initial indebtedness allows the country to smooth consumption more by borrowing from abroad, despite the increase in the interest premium. A less indebted economy suffers less in the crisis, at least in terms of consumption decline. (ii) Under perfect exchange rate flexibility, our model is capable to generate both the advantages and the disadvantages of a “competitive devaluation”. The export sector declines less on impact, and booms more after the export demand shock passes, but household balance sheets suffer more, due to a large depreciation of the exchange rate and a massive capital loss on foreign loans. (iii) Fixing the exchange rate protects households from the impact of the currency mismatch, but at the cost of a deeper drop in exports and employment. Based on this, we find that letting the exchange rate float freely would have been undesirable for the Hungarian economy. The tradeoffs between export performance and
consumption expenditures called for a muted exchange rate depreciation.

The paper is organized as follows. The next section describes the model. Section 3 presents our quantitative exercise: model calibration, the impact of the crisis, and the three counterfactual scenarios. Finally, Section 4 concludes.

2 The model

To understand the impact of the crisis, we build a two-sector small open economy model, based on the approach in Benczur and Konya (2011). The economy produces non-tradables and exports, while non-tradables and imports are used for consumption and investment. Households consume, invest into physical capital, supply labor, and allocate their financial assets between foreign bonds and domestic money holdings. Households pay an interest premium on foreign bonds, which depends on the indebtedness of the country as in Schmitt-Grohé and Uribe (2003), and hence taken as exogenous by households. Money is valued because it enters directly into the utility function.

Our goal is to have a framework with currency mismatch, non-linearity in the finance premium, and slow adjustment of real variables. As we show later, money-in-the-utility generates currency mismatch. The deterministic framework and the particular specification of the foreign interest premium allows for highly non-linear effects from foreign borrowing. Slow adjustment on the real side comes from investment adjustment costs at the sectoral level.

2.1 Production

Final composite investment and consumption goods are assembled from imported and non-tradable intermediate inputs. Export goods and non-tradables are produced domestically using capital and labor. Note that, following Burstein, Eichenbaum and Rebelo (2007), we assume that domestically produced tradables are exported, while tradables used in consumption and investment are imported. Capital is specific to a sector, and investment is subject to adjustment costs (see below at the household section). We use this assumption to prevent large reallocations across sectors; a similar assumption was used in Bems and Hartelius (2006).

2.1.1 Final goods

Investment in sectors T and NT and final consumption are aggregates of imported and non-tradable goods, and are assembled by competitive firms using Cobb-Douglas technologies. When describing the production technology for investment, it is important to account for the quadratic adjustment costs. Using $I_{jt}$ for investment in sector $j$ net of adjustment costs and $C_t$ for consumption, we can write the
production functions as follows: \(^1\)

\[
C_t = \lambda^{-\lambda} (1 - \lambda)^{\lambda^{-1}} \left( C_t^T \right)^{\lambda} \left( C_t^N \right)^{1-\lambda} \left( 1 + \frac{\phi I_{I,j,t}}{2 K_{I,j,t-1}} \right) I_{j,t} = \lambda^{-\lambda} (1 - \lambda)^{\lambda^{-1}} \left( I_{I,j,t}^T \right)^{\lambda} \left( I_{I,j,t}^N \right)^{1-\lambda},
\]

where \(\phi\) measures the extent of investment adjustment costs. Because we lack data on the tradable intensity of investment at the sectoral level, we assume that this intensity is not sector specific (\(\lambda_I\)).

Cost-minimization and free entry (zero profits) can be used to calculate the demand functions for the imported and non-tradable components of consumption and investment, and the price indexes for the final goods. We assume that only imported tradables are used in consumption and investment, as in Burstein, Eichenbaum and Rebelo (2007). The law of one price holds for import goods, and we normalize the foreign importable price to unity, so that \(P_t^T = S_t\), where \(S_t\) is the nominal exchange rate. Demand for imports and non-tradables in consumption and investment can be written as:

\[
S_t C_t^T = \lambda P_t^C C_t \tag{1}
\]

\[
P_t^N C_t^N = (1 - \lambda) P_t C_t \tag{2}
\]

\[
S_t I_{I,j,t}^T = \lambda_I P_t^I \left( 1 + \frac{\phi I_{I,j,t}}{2 K_{I,j,t-1}} \right) I_{j,t} \tag{3}
\]

\[
P_t^N I_{I,j,t}^N = (1 - \lambda_I) P_t^I \left( 1 + \frac{\phi I_{I,j,t}}{2 K_{I,j,t-1}} \right) I_{j,t}. \tag{4}
\]

The price indexes for consumption and investment are given by:

\[
P_t^C = S_t^\lambda \left( P_t^N \right)^{1-\lambda}
\]

\[
P_t^I = S_t^{\lambda_I} \left( P_t^N \right)^{1-\lambda_I}.
\]

### 2.1.2 Intermediate goods

Exports and non-tradables are produced using capital and labor. The production functions in both sectors are Cobb-Douglas:

\[
Y_{j} = K_{j,t}^{\alpha_j} N_{j,t}^{1-\alpha_j} \tag{5}
\]

where \(N_{j,t}\) is labor employed in sector \(j\), and \(K_{j,t}\) is capital used in sector \(j\).

Firms maximize profits, subject to factor prices \(W_t\) and \(r_{I,j,t}\) (measured in domestic currency):

\(^1\)Note that the subscript \(j\) indexes investment targeted towards the accumulation of capital in sector \(j\), while the superscripts indicate the tradable and non-tradable components of these investments.
The first-order conditions of the problem are given by

\[ r_{j,t}^k = P_t^j \alpha_j \left( \frac{K_{j,t}}{N_{j,t}} \right)^{\alpha_j - 1} \]

(6)

\[ W_t = P_t^j (1 - \alpha_j) \left( \frac{K_{j,t}}{N_{j,t}} \right)^{\alpha_j} \]

(7)

### 2.2 Households

Households can hold three types of assets: capital, interest bearing foreign bonds and non interest bearing domestic money. We assume that domestic money is not accepted by the rest of the world. For simplicity we also assume that domestic currency denominated bonds are not issued. Households can freely adjust their portfolios between money and bonds within a period. In addition, households accumulate capital for both the export and non-tradable sectors. As discussed above, investment is subject to quadratic adjustment costs.

Households draw income from (i) supplying labor, (ii) renting out capital to firms, and (iii) holding foreign bonds and domestic money. They allocate some of their income towards consumption and investment, and carry the remaining amount over to the next period in terms of financial assets. Although money does not pay interest, it is valued by households as it enters the utility function directly (money-in-the-utility). It can also yield a financial return in case of an exchange rate appreciation.

For accounting purposes we also introduce nominal bonds \( d_t \), which households use to acquire cash from the central bank. As in chapter 5 of Végh (2012), and without loss of generality, we assume that they do not pay interest.\(^2\) These bonds may or may not be accepted by the monetary authority, depending on the currency regime. Because they bear no interest, households want to sell as much as the central bank is willing to accept. We relegate the detailed description of monetary policy to the next section.

Households thus solve the following problem:

\[
\max_{K_{j,t}, N_{j,t}} \sum_{t=1}^{\infty} \beta^t \left[ \log c_t + \gamma \log \frac{H_t}{P_t} - \chi \frac{N_{j,t}^{1+\omega}}{1 + \omega} \right]
\]

s.t. \[ S_t (b_t - R_{t-1}b_{t-1}) + H_t - H_{t-1} - d_t + d_{t-1} = W_t N_t + \sum_{j=X,T} r_{j,t}^k K_{j,t-1} - P_t^j C_t - P_t^j \sum_{j=X,N} \left( 1 + \frac{\phi}{2 K_{j,t-1}} \right) I_{j,t-1} \]

\[ K_{j,t} = (1 - \delta) K_{j,t-1} + I_{j,t}, \]

\(^2\)Any interest revenue would be rebated to households by the central bank.
where $R_t$ is the discount rate on foreign currency denominated bonds $B_t$, $H_t$ is the stock of domestic money, and $N_t$ is the household’s labor supply.

After some simplification, the first-order conditions are written as follows:

\[
\frac{(P_{t+1}C_t/S_{t+1})}{(P_{t}C_t/S_{t})} C_{t+1} = \beta R_t \tag{8}
\]

\[
\chi N_t^{c} C_t = W_t \tag{9}
\]

\[
\frac{\gamma}{H_t} = \frac{1}{P_t^{c} C_t} - \frac{\beta}{P_{t+1}^{c} C_{t+1}} \tag{10}
\]

\[
q_{j,t} = 1 + \phi K_{j,t-1} \tag{11}
\]

\[
q_{j,t} = \left[ r_{j,t+1}^{k} + \frac{(1 - \delta)}{2} + \phi \left( \frac{I_{j,t+1}}{K_{j,t}} \right) \right] \frac{1}{R_t} \left( \frac{P_{t+1}^{I}}{P_t^{I}} \right)^{1-\lambda_t} \tag{12}
\]

\[
K_{j,t} = (1 - \delta) K_{j,t-1} + I_{j,t} \tag{13}
\]

The first equation is the consumption Euler equation, the second is labor supply, the third is money demand, the fourth is the investment equation where $q_{j,t}$ is Tobin’s q, the fifth is the arbitrage condition between investment and bonds, and the last is the capital accumulation equation (restated for convenience). Note that the last three equations must hold separately for $j = X, N$.

### 2.3 The central bank

We follow Végh (2012) in our description of the central bank balance sheet and in the definitions of a floating currency regime and a currency board. We assume that central bank assets include foreign currency $b_t^c$ and domestic non-interest bearing bonds $d_t$ issued by households.\(^3\) The per period budget constraint of the central bank is then given by:

\[
S_t (b_t^c - b_{t-1}^c) + d_t - d_{t-1} + T_t = H_t - H_{t-1}. \tag{14}
\]

The monetary policy regime is characterized by two parameters, $\rho_s$ and $\rho_h$. First, we posit the following policy rule:

\[
\left( \frac{H_t}{H_{t-1}} \right)^{\rho_s} \left( \frac{S_t}{S_{t-1}} \right)^{1-\rho_s} = 1. \tag{14}
\]

At one extreme ($\rho_s = 0$), the central bank follows a fixed exchange rate rule and accommodates changes

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\(^3\) The central banks could and do hold interest bearing foreign assets. In the crisis period, however, interest earned on safe foreign assets - such as US or German government securities - was essentially zero. We thus do not distinguish between foreign cash and other securities, but our analysis can easily be extended to take into account a more general foreign reserve composition.
in the money supply by changes in its foreign reserves. At the other extreme ($\rho_s = 1$), the money supply is fixed and the exchange rate is floating. Intermediate values of $\rho_s$ indicate the extent of the central bank’s desire to keep the exchange rate stable.

The central bank keeps foreign reserves to provide foreign currency liquidity when the currency does not freely floats. The following equation describes the extent of foreign reserve holdings:

$$b^c_t = \rho_h \frac{H_t}{S_t}.$$  \hspace{1cm} (15)

Under a pure float, we assume that $\rho_h = 0$. Under a fixed exchange rate, we assume that $\rho_h = 1$; this is equivalent to a currency board. In intermediate cases we view $\rho_h$ as a calibration target and do not analyze the question of the optimal size of foreign reserve holdings.

Note that the monetary authority manipulates the exchange rate through changes in reserves, or in other words through its commitment to exchange foreign currency for domestic. Plugging equation (15) into equation (14) for the cases where $\rho_h > 0$, we get:

$$\frac{H_t}{H_{t-1}} = \left(\frac{b^c_t}{b^c_{t-1}}\right)^{1-\rho_s}.$$

The equation highlights the extent to which increases in money demand lead to changes in foreign reserves. When the exchange rate is fixed, the money supply changes only through reserves. Under a pure float, the money supply is fixed (we thus implicitly assume no helicopter drop money creation, i.e. $d_t = d_{t-1}$).

### 2.4 Equilibrium

To ensure the existence of a well-defined steady state in small open economy models, the literature has used various short-cuts, summarized in Schmitt-Grohé and Uribe (2003). These shortcuts essentially amount to selecting a level for the steady state NFA. We follow the literature in allowing for a debt-dependent interest rate, but we use a more general functional form that allows for asymmetry between debt and assets, and an upper limit to foreign borrowing. More precisely, we assume that the foreign interest rate is given by:

$$\log R_t = -\log \beta + \nu \frac{e^{-\zeta b_t/Y_t} - \zeta b_t/Y_t - 1}{\zeta^2},$$  \hspace{1cm} (16)

where the last term is a modified Linex function, and $Y_t = \left(\frac{P_t^X}{S_t}\right)Y_t^X + \left(\frac{P_t^N}{S_t}\right)Y_t^N$ is GDP measured in foreign currency. Figure 1 shows the properties of this specification relative to the standard exponential function used by Schmitt-Grohé and Uribe (2003).

The nice feature of the Linex specification is that it captures three aspects of the interest premium.
that we consider important: (i) (almost) constant interest rate on assets, (iii) quickly rising premium for large debt, and (iii) (almost) existence of an absolute borrowing constraint. Although (i) and (iii) do not hold exactly, one get get arbitrarily close while preserving the smoothness of the premium function by increasing the parameter $\zeta$.

Note that the interest rate depends on foreign debt incurred by households.\footnote{In our interpretation and calibration the household sector also includes public debt and government consumption and investment.} In particular, we do not consolidate $b_t$ with central bank reserves $b_c$. The assumption behind this is that reserves are only used for liquidity provision, but not for bailing out households (or the government). Thus the riskiness of the country - measured by the interest premium - does not depend on the amount of foreign reserves.

Now we specify market clearing conditions for non-tradables, exports and imports. Non-tradable market clearing requires that production equals consumption plus investment:

$$K_{N,t}^{1-\alpha_N} = C_{N,t} + I_{N,t}^{N} + I_{N,t}^{N}$$ (17)

Figure 1: The linex function

![Figure 1: The linex function](image)
We assume that exporters face a downward sloping demand curve:

\[ Y_t^X = A \left( \frac{P_t^X}{S_t} \right)^{-\eta}, \]  

(18)

where demand depends on the foreign price of the good.

To derive the current account from the household budget constraint, we use the condition that \( d_t = H_t - S_t b_t^c = (1 - \rho_h) H_t \) to get:

\[
\frac{b_t}{R_t} - b_{t-1} + \rho_h \frac{H_t - H_{t-1}}{S_t} \frac{P_t^X}{S_t} - Y_t^X = C_{T,t} - i_{T,t} - i_{N,t}.
\]  

(19)

Under pure floating \((\rho_s = 1, \rho_h = 0)\), money does not enter the current account, and the model is equivalent with a cashless economy (a “real model”) with money determined residually. With a currency board \((\rho_s = 0, \rho_h = 1)\), changes in money demand have to be matched by equivalent changes in central bank reserves. Thus in order to increase (decrease) money holdings, the country has to run a current account deficit (surplus).

It is illuminating to write down the evolution of net foreign assets, which also includes central bank reserves. To derive the general formula, let \( R_t^c \) indicate the gross interest rate that reserves earn (in our specific case \( R_t^c = 1 \), as discussed above). Moreover, let \( B_t = b_t + b_t^c \) denote net foreign assets. Using the household and central bank budget constraints, it is easy to show that the evolution of \( B_t \) is given by:

\[
B_t - R_{t-1} B_{t-1} = T B_t - \rho_h \left( R_{t-1} - R_{t-1}^c \right) \frac{H_{t-1}}{S_{t-1}},
\]

where \( TB_t \) is the trade balance denominated in foreign currency.

This equation makes it clear that currency mismatch operates through two channels in this framework. First, as long as the central bank earns a lower interest rate on reserves than what households pay on foreign debt, holding money (the domestic currency asset) has a real cost for the economy; moreover, the crisis impacts the economy differently through this channel depending on the currency regime. Second, if reserves \((b_t^c)\) and non-reserve foreign debt \((-b_t)\) are not equivalent in their impact on the external interest premium, opposing changes in \(b_t^c\) and \(b_t\) - which keep \(B_t\) constant - will still have a real effect through a change in the interest premium.

In our model both of these channels are operational, since we assume \( R_t > R_t^c = 1 \) and only \( b_t \) enters the interest premium function. When looking at the impact of the crisis through currency mismatch, the second channel dominates. Defending the exchange rate allows households to build down domestic savings \((H_t)\), and pay back foreign debt \((b_t)\), thereby reducing the external interest premium. This leads to a decrease in central bank reserves and hence in the overall NFA position \((B_t)\), but that has no additional
impact on the interest rate \( R_t \). Allowing the exchange rate to depreciate more, on the other hand, decreases the foreign currency value of domestic assets, and hence makes households less able to draw on domestic savings to protect consumption.

To sum up, equations (1), (2), (3), (4), (6), (7), (8), (9), (10), (11), (12), (13), (14), (16), (17), (18) and (19) jointly determine the endogenous variables. This is a system of nonlinear difference equations. Since our model is deterministic, we can use DYNARE to get an arbitrarily precise solution without resorting to log-linearization. This is important since our specified interest premium relationship is highly nonlinear; one strength of our approach is that we can keep this nonlinearity in our solution method.

3 The experiment

Now we use our model to understand crucial aspects of the financial crisis of 2008 in our small open economy. As we discussed in the Introduction, the important aspects are (i) an external shock to the interest premium, and (ii) a large temporary decline in export demand.

We set up the experiment to replicate important features of the Hungarian experience. As explained earlier, we present simulations from a deterministic model, where the economy is initially in steady state. There are two shocks that unexpectedly hit the economy: a one-period drop in export demand, and a permanent change in the amount of foreign indebtedness that markets are willing to tolerate. More precisely, we lower the parameter \( A \) in equation (18) for one period, and move the steady state NFA per GDP level \( \bar{b}/\bar{Y} \) to a higher (less negative) level. Thus we trace out the response of the economy as it moves from the initial steady state to a new steady state with lower indebtedness.

The one-period export demand shock is included to match the short-run response of the economy better. Also, one can debate if the change in foreign debt tolerance is really permanent. We use this assumption to substitute for an arbitrary end period, and because we do think the external adjustment is here to stay for a long time.

3.1 Calibration

Figure 2 plots the 5-year CDS spreads for Hungary, the Czech Republic, and Slovakia in the 2008-2011 period. We pick the parameters of the linex function to roughly match this figure. We assume that before the crisis the long-run value of NFA per GDP was -1 (the Hungarian level), and the impact of the crisis was to move this value to zero. From Figure 1 we can see that the impact of such a move is to increase the financing premium depending on where the country was initially. The linex parameters are then chosen so that we reproduce the premium increase in the first period into the crisis of about 400 basis point (Hungary), and of about 100 basis point (Slovakia and the Czech Republic). These considerations lead
to the parameter values of $\nu = 0.01$ and $\zeta = 2$, and this is what we plotted on Figure 1.

Figure 2: CDS spreads in the Czech Republic (solid), Hungary (short dash) and Slovakia (long dash)

We normalize the export demand shift parameter in the steady state to $A = 1$. We then set the one-period shock to $A' = 0.6$, with which we match the decline in employment. Note that the parameter change in itself has no meaning, and its only function is to generate an endogenous decline in equilibrium employment and exports. These, of course, also depend on the elasticity of export demand (set to unity), and on many other parameters through general equilibrium effects.

The discount factor is calibrated to yield an annual real interest rate of 4%. The depreciation rate is a standard value in the literature, and corresponds to a steady state investment ratio of about 0.25 in both sectors (inclusive of adjustment costs). The shares of tradables in consumption and investment, and the sectoral capital shares, come from sectoral national accounts, where we classify sectors A, B, C, D and I as tradables, and the rest of the economy as non-tradables. Based on Benczur and Konya (2011), we choose parameter values by simply averaging across countries in the CEE region.

The labor supply elasticity is a standard value in the macro literature. Capital adjustment costs are based on Cummins, Hassett and Hubbard (1996) and Cummins, Hassett and Oliner (2006). These papers imply a range of $2 - 7.5$, of which we take a number close to the midpoint. Steady state labor supply is calibrated to a 0.7 employment rate, with weekly hours of 40, relative to a total of $7 \cdot 16$. The parameter on money-in-the-utility is calibrated to the Euro area average of the M1 per GDP ratio.

As discussed above, we set the initial NFA per GDP ratio to the Hungarian value of -1 at the onset
Table 1: Calibrated parameters and initial conditions

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<thead>
<tr>
<th>Parameter</th>
<th>Notation</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount factor</td>
<td>$\beta$</td>
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</tr>
<tr>
<td>Depreciation</td>
<td>$\delta$</td>
<td>0.06</td>
</tr>
<tr>
<td>Tradables in C</td>
<td>$\eta$</td>
<td>0.36</td>
</tr>
<tr>
<td>Tradables in I</td>
<td>$\eta_I$</td>
<td>0.44</td>
</tr>
<tr>
<td>Capital share in T</td>
<td>$\alpha_T$</td>
<td>0.42</td>
</tr>
<tr>
<td>Capital share in N</td>
<td>$\alpha_N$</td>
<td>0.37</td>
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<tr>
<td>Labor supply elasticity</td>
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<td>1/2</td>
</tr>
<tr>
<td>Capital adjustment cost</td>
<td>$\phi$</td>
<td>5</td>
</tr>
<tr>
<td>Steady state labor</td>
<td>$\bar{N}$</td>
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</tr>
<tr>
<td>Steady state M1/Y</td>
<td>$\bar{H}/\bar{Y}$</td>
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</tr>
<tr>
<td>Monetary policy</td>
<td>$\rho_s$</td>
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<tr>
<td>Reserve ratio</td>
<td>$\rho_h$</td>
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<tr>
<td>Export demand elasticity</td>
<td>$-\eta$</td>
<td>1</td>
</tr>
<tr>
<td>Initial NFA position</td>
<td>$B_0/Y_1$</td>
<td>-1</td>
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</table>

of the crisis in Q42008. The new steady state NFA per GDP is set to zero. Monetary policy targets the exchange rate and the money stock. In our baseline simulation - motivated by the Hungarian experience - we assume dirty floating with $\rho_s = 0.25$. This value replicates the exchange rate drop of the HUF relative to the Euro that we see in the data between 2008 and 2009. We set $\rho_h = 1$, implying that reserves were equivalent in magnitude to the money supply (M1). This is close to the Hungarian average (1.045) over the sample period 2001-2011, with some interesting dynamics that we do not model in this exercise. Finally, the elasticity of export demand is chosen somewhat arbitrarily to a value that (i) is not too high, and (ii) the numerical solution exists. The results are not sensitive to moderate variations in this parameter.

3.2 Results

We plot the results of four simulations. First, we present the baseline case using the calibration we discussed in the previous section. In particular, we set the initial level of NFA per GDP to -1, and the monetary policy parameters to $\rho_s = 0.25$ and $\rho_h = 1$. This, we believe, captures key features of the Hungarian economy when it was hit by the dual shocks to the financing premium and export demand. Our goal in the baseline scenario is to demonstrate that our calibrated model provides a reasonable quantitative description of crisis events.

In addition to the baseline, we explore three counterfactuals. First, we evaluate the impact of the crisis when the initial level of indebtedness is lower, $b_0/Y_0 = -0.5$. This corresponds to the Slovak value, and is close to the Czech value. Next, we return the initial NFA per GDP ratio to -1, but change monetary policy. We explore the extreme cases of full exchange rate flexibility ($\rho_s = 1, \rho_h = 0$) and a fixed exchange rate ($\rho_s = 0, \rho_h = 1$).
We are interested in the responses of consumption and employment under these alternative arrangements. We expect that a flexible exchange rate smooths adjustment to the export demand shock, and hence protects employment in that sector. On the other hand, because of currency mismatch, a fixed exchange rate protects the balance sheet of households. Our goal is to quantitatively evaluate the strength of these two channels under alternative exchange rate arrangements.

3.2.1 The baseline

Figure 3 shows selected variables under the baseline simulation. The stars represent changes we see in the data, to give a sense of the quantitative performance of the model. Our pre-crisis baseline year is 2008, and we have data for 2009 and 2010 after the crisis hit. Four issues are worth noting. First, the almost perfect match of the exchange rate, interest rate and employment changes are due to our calibration strategy. Second, to measure the change in the money stock, we used M1, and computed the deviation from the 2001-2008 growth rate adjusted by 4% inflation. Third, our measure of the relative price change is relative to the trend between 2001-2008, where the non-tradable relative price increased by 5.2% annually.\(^5\) We begin the sample period in 2001 because that was the year when a new monetary

\(^5\)We measure the relative price by the ratio of the price of market services to the price of manufactures.
regime, inflation targeting, was introduced in Hungary. Forth, the pre-crisis current account showed an average deficit of 6%, so our data values represent improvements relative to that level (since our model simulation starts at a current account level of zero).

Figure 3 demonstrates that the model does a reasonably good job matching the impact of the crisis over the first two years. The net foreign asset position worsens initially, then begins to improve. While the current account is positive from the first period, the 20% devaluation of the exchange rate causes GDP measured in foreign currency to plunge. The NFA stock is denominated in foreign currency, hence the large initial valuation effect we see on the figure. The magnitude of the changes is quite close to what we observe in the data, although the model overpredicts these somewhat for the first year, and underpredicts them in the second. The current account is more volatile in the model, which is a consequence of the assumption that the export demand shock lasts only for one period. Preliminary data suggests that the third period (2011) value of the current account is again closer to the model.

Of the other variables not used in the calibration, the export drop is somewhat lower than in the data in the first year, and exports rebound much faster. Again, we expect the 2011 data point to be closer to the simulation. The relative price change in the data is a bit less than half of what the model predicts in the first year, due probably to a slower exchange rate pass-through than assumed. Note, however, that we are remarkably successful in matching the relative price change over the first two periods.

The money stock change in the data is much less than the model’s prediction. This is an issue we need to explore further. The intuition the model captures is that households smooth consumption by using their saving as a buffer. In the model, these are in the form of money, but there are probably other forms of domestic savings we would need to take into account. Clearly this is a tradeoff between model simplicity and a more realistic asset structure. Another possibility is that due to the crisis, households have an increased demand for liquidity (or precautionary savings), which we could introduce as an increase in the parameter $\gamma$. Note that while the consumption drop is somewhat higher in the data, the model does a pretty good job in both periods.

Overall, while not perfect, we judge the model’s ability to fit key macroeconomic variables to be very good. All variables move in the expected direction, and the magnitudes are also reasonable. There is a puzzle regarding the magnitude of the money stock declines, and some of the short-run dynamics (current account, relative price) appears to be at odds with the data. This can be either the consequence of our flexible price assumption, or the specification of the export demand shock.

### 3.2.2 Counterfactuals

Figure 4 presents the results from the different simulations. The solid lines are the baseline described above, the starred lines correspond to the case of low initial indebtedness ($b_0/Y_0 = -0.5$), the lines with
pluses represent the fixed exchange rate case, and the lines with circles correspond to the flexible exchange rate case.

Lower initial indebtedness allows the country to smooth consumption more by borrowing from abroad, despite the increase in interest premium. In the Czech Republic and Slovakia, the current account was negative in 2009 - −2% and −2.5% of GDP, respectively. The tradable sector contracts by more, since the direct impact of the one-period decrease in export demand dominates. Employment overall falls more, given the less prominent income effect than under the baseline. Overall, a less indebted economy suffers less in the crisis, as expected, at least in terms of consumption decline.

More interesting are the simulations under the two extreme exchange rate regimes. Under perfect flexibility, the exchange rate depreciates by about 33% (not shown), and as a result, both the interest premium and the NFA per GDP position worsen dramatically. Instead of the baseline 400 basis point, the interest spread rises by 800 basis points. Consumption falls the most under this scenario, but tradable production and overall employment decline the least. Thus our model is capable to generate both the advantages and the disadvantages of a competitive devaluation. The export sector declines less and booms more after the export demand shock passes, but household balance sheets suffer more.
Fixing the exchange rate protects households from the impact of the currency mismatch, but at the cost of a deeper drop in exports. Consumption declines the least under this regime, but the recession - in terms of employment - is the deepest. Welfare implications should be drawn cautiously, since employment is actually undesirable in our representative household framework. In a more realistic setup with heterogeneity, the employment decline may lead to a steep income and consumption loss for particular households.

Overall, we conclude that given the high level of indebtedness and currency mismatch, letting the exchange rate float freely would have been undesirable for the Hungarian economy. Defending the export sector would have come at the cost of a much larger increase in the interest premium, indebtedness, and a much bigger drop in consumption.

4 Conclusion

We presented a simple two-sector small open economy model with a meaningful nominal and external financing side, which we utilized to study the adjustment process of a small open economy to a sudden worsening of external conditions. Our main contribution is a highly non-linear specification of the endogenous external finance premium that can capture credit constraints in a convenient way. This is made possible by the fact that we work in a deterministic framework, and hence we are able to solve the model nonlinearly, even for a highly nonlinear and asymmetric specification for the interest premium function.

We calibrate the model to the performance of the Hungarian economy in the 2000s and its 2008 crisis experience in particular. The main shock we are interested in is a permanent tightening of external credit conditions, implemented as a rise in the foreign interest premium. In order to match the initial developments in these countries, we add a second, one period shock that captures the large drop in foreign demand. Then we also compute three counterfactuals: one with smaller initial indebtedness, and two with different exchange rate policies (free float and a perfect peg).

Overall, we judge the model’s ability to fit key macroeconomic variables to be very good: all variables move in the expected direction, and the magnitudes are reasonable. Our model also generates a quantitatively meaningful tradeoff between letting the currency depreciate and allowing for a quicker real adjustment of the economy, versus protecting consumption expenditures by limiting exchange rate movements and saving household balance sheets.
References


