Lending of Last Resort in an Open Economy

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Abstract

The paper analyzes a small open economy with flexible exchange rates in which the financial sector is possibly subject to confidence crises. We show that a feedback between the health of the financial sector and the exchange rate amplifies the effects of the crisis. Moreover, we show that foreign reserves may be needed to credibly support the financial sector through lending of last resort. The paper shows that even if the domestic banking sector is initially financed mostly with domestic deposits in domestic currency, a two-phase crisis can take place in which first consumers fly from domestic currency deposits, pushing the banks to dollarize their liabilities, and next the country is subject to a bank run cum currency crisis. In this context, precautionary reserve accumulation by the central bank leads to a less dollarized financial sector and to a more stable exchange rate.