Implications of Economic Openness for Financial Crises

Yu-Ning Hwang*
Assistant Professor of the Department of Economics, National Changchi University
Fu-Min Yang
Master, Department of Economics, National Chengchi University

Abstract

The objective of this study is to examine how exchange rate flexibility and economic openness influence the transmission of financial shock in the credit market. To illustrate the failure of cautious monitoring for loans (the common cause of historical financial crises as well as the 2007 subprime crisis that spread rapidly through globalization), we perform a quantitative examination by calibration a dynamic stochastic general equilibrium (DSGE) model with costly loan-making in a small open economy. The numerical results show that the shock to the bank's productivity in the loan-making drives up the home bond rate, which causes the home currency to appreciate, thereby reducing production. In summary, the floating exchange rate amplifies the adverse effect of financial shock on the real sector, and its influence rises with the degree of openness.

Keywords: Credit Channel; External Financial Premium; Flexible Exchange Rate; Financial Crisis

JEL Classifications: E43, E51, F31, F41

* Corresponding author. Department of Economics, National Chengchi University, 64, Sec. 2, Tz-nan Rd., Wenshan, Taipei 116, Taiwan. Tel.: 886-2-29393091 ext. 51041. Email: yuning@nccu.edu.tw.