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Abstract

This paper provides a model of boom–bust episodes in middle-income countries. It is based on sectoral differences in corporate finance: the nontradables sector is special in that it faces a contract enforceability problem and enjoys bailout guarantees. As a result, currency mismatch and borrowing constraints arise endogenously in that sector. This sectoral asymmetry allows the model to replicate the main features of observed boom–bust episodes. In particular, episodes begin with a lending boom and a real appreciation, peak in a self-fulfilling crisis during which a real depreciation coincides with widespread bankruptcies, and end in a recession and credit crunch. The nontradables sector accounts for most of the volatility in output and credit.

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