

- We will now investigate conditions under which currency crises emerge.
- Currency crises mainly affect developing countries and are characterised by the sudden devaluation of the currency without apparent cause justifying such a larger change.
- The economic consequences of currency crises can be significant, especially if they trigger or are trigger by a banking crisis.
- We will here focus our attention on the effect on the exchange rate itself, not its wider economic implications.

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 - It is also said that this reduces uncertainties in international trade and the stability of the exchange rate makes foreign investments more
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- What we often see is that currencies fluctuate in a narrow band, which often drifts over time.
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 - Such sudden devaluations have significant macroeconomic consequences and although we do not consider them here in detail, they show the
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 - If the devaluation of the currency is not justified by a sudden change in macroeconomic factors, we refer to a 'currency crisis'.
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- → We can in principle distinguish two types of currency crises, one where there is a macroeconomic vulnerability that leads to an exaggerated adjustment of the exchange rate and the other where there is no such vulnerability, but a currency crisis emerges due to the expectations of market participants.
- In many cases macro economic conditions in a country affected by a currency crisis were such that any small change in this conditions would trigger processes that would result in significant adjustments in the economy, including the exchange rate. Such countries are therefore vulnerable to seemingly small events having a significant impact on they.
- Once investors become aware of events that are likely to trigger a currency crisis, they might well 'jump ahead' and anticipate the currency crisis
 emerging, accelerating the devaluation of the currency. This is then referred to as a speculative attack; but these are often only the result of already
 present vulnerabilities and the process is only accelerated.
- However, at other times no such vulnerabilities exist and it is only the behaviour of investors forcing policy makers to devalue their currency. This can occur if market expectations on the sustainability of an exchange rate change and in reaction to this, the policy maker faces too high costs in maintaining the existing exchange rate.
- ► The following models will consider both types of currency crises.
- We have to distinguish models of currency crises with those of models for a wider economic crises where changes to the exchange rate have a basis in macroeconomic conditions. We are here only interested in models where the macroeconomic conditions do not justify the observed devaluation of the currency.

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- Currency crises are most traced back to macroeconomic imbalances that make countries vulnerable
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Speculative attacks

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- We will first look at a model of what is sometimes referred to as 'speculative attacks' on a currency.
- ► The idea of this model is that a currency crisis is not triggered by weakening macroeconomic conditions, but merely by the expectations of market participants that a currency crisis will occur.
- Once a country has reached a state where the macroeconomic conditions are such that the current exchange rate can be maintained, but an alternative
 is also sustainable, a currency crisis can be triggered by changing opinions on the likelihood of a currency crisis.
 - We will see that once expectations change, a different equilibrium is reached,
- and this change of equilibrium causes the currency crisis as the exchange rate changes significantly.
- ▶ We will explore how such a change in expectations can cause such a currency crisis and what conditions are required for such a possibility.
- → we will now present a simple macroeconomic model that prominently includes the exchange rate as a key component.

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- ▶ While currency crises often have their origin in macroeconomic imbalances, a currency crisis can be triggered by changing expectations about the policy maker's decision
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- ► We will look at how expectations can become self-fulfilling if a country is sufficiently vulnerable due to its macroeconomic performance

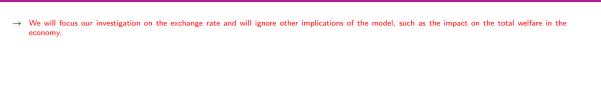
- → We will first look at a model of what is sometimes referred to as 'speculative attacks' on a currency.
- ► The idea of this model is that a currency crisis is not triggered by weakening macroeconomic conditions, but merely by the expectations of market participants that a currency crisis will occur.
- ▶ Once a country has reached a state where the macroeconomic conditions are such that the current exchange rate can be maintained, but an alternative is also sustainable, a currency crisis can be triggered by changing opinions on the likelihood of a currency crisis.
 - We will see that once expectations change, a different equilibrium is reached,
- and this change of equilibrium causes the currency crisis as the exchange rate changes significantly.
- We will explore how such a change in expectations can cause such a currency crisis and what conditions are required for such a possibility.
- ightarrow we will now present a simple macroeconomic model that prominently includes the exchange rate as a key component.

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- ▶ While currency crises often have their origin in macroeconomic imbalances, a currency crisis can be triggered by changing expectations about the policy maker's decision
- ► Once a country is vulnerable, expectations might change from expecting the policy maker to maintain the exchange rate to changing it
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Currency crises Slide 5 of 10

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- → The model has highlighted that in some circumstances expectations play a central role for the stability of exchange rates or the emergence of a currency crisis.
- We have seen that in some cases we can multiple equilibria; This is the case if the economy is weakened, but still sufficient robust to maintain a stable exchange rate.
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- ▶ We have called such expectations self-fulfilling because if a currency crisis is expected, it will occur, while if it is not expected, it will not occur.
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- ▶ [1] The key part is whether the market believes that this is what is going to happen. If the market believes that the central bank will defend the current exchange rate 'at all costs', the expectations will be that no currency crisis will occur and hence none will occur. However, if there are doubts about their willing ness to defend the exchange rate, the expectations might change and a currency crisis will be triggered, regardless of the central bank's reassurances.
- → Thus it is central for policy makers not only to have sound policies in place, but also to have the trust of market participants.

Multiple equilibria can emerge if a country's economy is weakened and once expectations about the stability of the currency change, it is optimal to adjust its exchange rate

currency crisis

If the policy maker re-affirms that the exchange rate will be kept stable, will that the ensure a currency crisis is averted?

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 - Lower investment will affect the economy, such as production and consumption,
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- → We have seen that some countries may be susceptible to currency crises and a small change in macroeconomic condition can trigger a change of the equilibrium, causing a disproportionate change in the exchange rate.
- We have seen that vulnerable countries are those that rely on large foreign debt,
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- A small change in the current account or in capital flows in the model set in motion a dynamic adjustment process to return the economy to an
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- → We can now summarize some key points about currency crises.
- ▶ Generally, countries become susceptible to currency crises due them exhibiting weak macroeconomic conditions.
 - Weak macroeconomic conditions can then open the door for self-fulfilling expectations to trigger a currency crisis
- or small shock might trigger an adjustment process that results in a change of equilibrium, that causes a currency crisis.
- The key origin in all cases are the weak macroeconomic conditions, but the mechanisms that triggers the currency crisis differ.
 - We might not see a significant change in the fundamentals of the economy, or even none at all.
- The large adjustments we observe in the exchange rate are the result of expectations changing
 - or the economy adjusting to a different equilibrium.
- → Currency crises are very visible events with a large change in the exchange rate, but we have seen that the events triggering such a currency crisis do not need to be significant in itself; this makes identifying the cause of a specific currency crisis difficult.

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