Andreas Krause
Currency crises

Stable exchange rates

- Exchange rates are rarely fixed by a country, but often policy makers seek to maintain a stable exchange rate
- This is to avoid importing inflation and reduce the risk in any cross-border transactions
- Often observe a slow but steady change of the exchange rate, but occasionally large and sudden changes are observed
- These large and sudden changes are often associated with macroeconomic upheavals and are known as currency crises

Types of currency crises

- Currency crises are most traced back to macroeconomic imbalances that make countries vulnerable
- The final events leading to a currency crisis is often referred to as a speculative attack on the currency
- At other times, policy makers come under pressure from the markets to re-value their currency as the current exchange rate is no longer sustainable
- We will discuss both types of currency crises

Speculative attacks

- 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
- If expectations change, the equilibrium can change and cause a currency crisis
- We will look at how expectations can become self-fulfilling if a country is sufficiently vulnerable due to its macroeconomic performance

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Self-fulfilling currency crises
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The importance of expectations

- 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
- As the currency crisis only emerges if it is expected to emerge, it is a self-fulfilling currency crisis

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

! While a policy maker can give such assurances, it is whether the market believes them as the costs of changing the exchange rate is lower; if the market believes the policy maker to give in to pressure, a currency crisis will happen

Weak macroeconomic fundamentals

- While expectations are important, exchange rates are determined by macroeconomic conditions and they in turn affect macroeconomic conditions
- A devalued currency will affect investments negatively as less resources are available if foreign debt has to be serviced
- These lower investments will affect the economy and in a downward spiral can cause a currency crisis
- We will determine which factors make a country vulnerable to such currency crises

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Vulnerability to currency crises

- Countries relying on foreign debt, a current account surplus, and being highly leveraged are vulnerable to devaluations
- These devaluations are required to return the economy to an equilibrium and the devaluation might be in no proportion to the size of the cause

? A currency devalues significantly; is this inevitably a sign for a currency crises?

! Currency crises are based on weak macroeconomic fundamentals that cause the currency crises, but a devaluation was in no relation to the size of the shock. A sharp devaluation could also be the result of much worsening macroeconomic fundamentals and be fully justified by the size of the shock.

Summary of key results

- Countries are vulnerable to currency crises from weak macroeconomic fundamentals
- Such weak macroeconomic fundamentals can cause self-fulfilling expectations or a change of the exchange rate to return the country to equilibrium
- The origin of currency crises are weak macroeconomic fundamentals, although the timing of the currency crisis might not show a significant change in them
- They are caused by changing expectations or an adjustment by the economy to a new equilibrium after a (minor) shock

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