



Self-fulfilling currency crises

Outline

- The importance of expectations
- Flexible exchange rate
- Fixed exchange rate
- Optimal exchange rate regime
- Summary

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Managing macroeconomic variables

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Crashes without information

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- ▶ A currency crisis emerges if the exchange rate undergoes a sudden change **without** the change of economic fundamentals

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Minimizing costs from inflation and taxation

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▶ $\Pi = \pi^2$

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- ▶ $\Pi = \alpha\pi^2 + T^2$

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Self-fulfilling expectations

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- ▶ If the exchange rate is **expected to remain fixed**, $E[\Delta e] = 0$, the exchange rate **will remain fixed**

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- ▶ If the exchange rate is expected to remain fixed, $E[\Delta e] = 0$, the exchange rate will remain fixed
- ▶ If the exchange rate is **expected to change**, $E[\Delta e] = \frac{\theta}{\alpha} rB$, the exchange rate **will change**

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- ▶ A change in the exchange rate becomes self-fulfilling
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- ▶ As $\Delta e = E[\Delta e] = \frac{\theta}{\alpha} rB > 0$, this will be a depreciation of the exchange rate such that **inflation is induced** to reduce the real value of debt

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- ▶ A depreciation is inevitable if the debt burden of a country is high as the resulting inflation will reduce the debt burden
- ▶ A depreciation is **not rational** if the **debt burden** of a country is **low** as the costs of abandoning the fixed exchange rate does not outweigh the reduced debt burden from higher inflation

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- ▶ A depreciation is not rational if the debt burden of a country is low as the costs of abandoning the fixed exchange rate does not outweigh the reduced debt burden from higher inflation
- ▶ With **intermediate debt burdens**, a currency crisis can become **self-fulfilling**

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- ▶ If the current exchange rate regime is **not expected to change**, a currency crisis is avoided

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