A NOTE ON CURRENCY CRISIS

Since the early 1990s, there have been many cases of currency investors who have been caught off guard, which lead to runs on currencies and capital flight. What makes currency investors and international financiers respond and act like this? Do they evaluate the minutia of an economy, or do they go by gut instinct? In this article, we'll look at currency instability and uncover what really causes it.

What Is a Currency Crisis?

A currency crisis is brought on by a decline in the value of a country's currency. This decline in value negatively affects an economy by creating instabilities in exchange rates, meaning that one unit of the currency no longer buys as much as it used to in another. To simplify the matter, we can say that crises develop as an interaction between investor expectations and what those expectations cause to happen.

Government Policy, Central Banks and the Role of Investors

When faced with the prospect of a currency crisis, central bankers in a fixed exchange rate economy can try to maintain the current fixed exchange rate by eating into the country's foreign reserves, or letting the exchange rate fluctuate.

Why is tapping into foreign reserves a solution? When the market expects devaluation, downward pressure placed on the currency can really only be offset by an increase in the interest rate. In order to increase the rate, the central bank has to shrink the money supply, which in turn increases demand for the currency. The bank can do this by selling off foreign reserves to create a capital outflow. When the bank sells a portion of its foreign reserves, it receives payment in the form of the domestic currency, which it holds out of circulation as an asset.

Propping up the exchange rate cannot last forever, both in terms of a decline in foreign reserves as well as political and economic factors, such as rising unemployment. Devaluing the currency by increasing the fixed exchange rate results in domestic goods being cheaper than foreign goods, which boosts demand for workers and increases output. In the short run devaluation also increases interest rates, which must be offset by the central bank through an increase in the money supply and an increase in foreign reserves. As mentioned earlier, propping up a fixed exchange rate can eat through a country's reserves quickly, and devaluing the currency can add back reserves.

Unfortunately for banks, but fortunately for you, investors are well aware that a devaluation strategy can be used, and can build this into their expectations. If the market expects the central bank to devalue the currency, which would increase the exchange rate, the possibility of boosting foreign reserves through an increase in aggregate demand is not realized. Instead, the central bank must use its reserves to shrink the money supply, which increases the domestic interest rate.

Anatomy of a Crisis

If investors' confidence in the stability of an economy is eroded, then they will try to get their money out of the country. This is referred to as capital flight. Once investors have sold their domestic-currency denominated investments, they convert those investments into foreign currency. This causes the exchange rate to get even worse, resulting in a run on the currency, which can then make it nearly impossible for the country to finance its capital spending.

Predicting when a country will run into a currency crisis involves the analysis of a diverse and complex set of variables. There are a couple of common factors linking the more recent crises:

- The countries borrowed heavily (current account deficits)
- Currency values increased rapidly
- Uncertainty over the government's actions made investors jittery

Efficient central bank management can help, but predicting the route an economy will ultimately take is a tough journey to map out.