Week 6: International Finance. Krugman, Paul. 1998. "Currency Crises"

Main question: Are currency crises always justified?

Main Explanation: Krugman explains that currency crises are not always justified. In other words, he cites different scenarios, in which currency crises are not driven by countries' fundamentals. These scenarios are self-fulfilling crises, herding behaviors, machinations of large agents, and contagion.

Krugman first rejects the canonical model – the first generation model – and the second generation model as inadequately explaining the currency crises. Both models basically explain that there is something wrong with the country's fundamentals, which generate the currency crises. Krugman then gives explanations that go beyond these fundamentals argument. However, he also points out that these models still have caveats.

1) Self-fulfilling crises: An investor will not pull his money out of the country if he believes that the currency regime is in no imminent danger; but he will do so if a currency collapse seems likely. A crisis, however, will materialize precisely if many individual investors do pull their money out. The result is that either optimism or pessimism will be self-confirming; and the in the case of self-confirming pessimism, a country will be justified in claiming that it suffered an unnecessary crisis.

   The caveat of this model is that it does not imply either that any currency can be subject to speculative attack or that all speculative attacks are unjustified by fundamentals.

2) Herding: A wave of selling stocks, pushing the prices down, could be magnified through sheer imitation and turn into a stampede out of the currency. Aside from the biases and limitations of human cognition, herding occurs because of two other reasons. The first one is bandwagon effect driven by the awareness that investors have private information. The second answer is that much of the money invested in crisis-prone countries is managed by agents rather than directly by principals. All agents will want to act alike because they are compensated by their performances compared to others even if they have information that the market's judgment is in fact wrong.

3) Contagion: Linkages between the countries explain contagion: a currency crisis in country A worsens the fundamentals in country B. It prompts to a competitive devaluation in order to remain competitive in trade.

   A caveat of this explanation for the three crises in the 1990s: European, Latin America, and Asian is that the trade links are fairly weak in the European and Asian cases. Mexico is neither an important market nor an important competitor for Argentina. Two rational explanations fix this caveat. One is that countries are perceived as a group. Once investors see one country with that cultural background abandon its peg under pressure, they may revise downward their estimate of the willingness of other such countries to defend their parities. Another reason is that political commitment to a fixed exchange rate is itself subject to herding effects.

4) Market manipulation by large agents: buy currency at a cheap and sell at a higher rate but in an ostentatiously large amount by identifiable agents except for Soros.

I don't think that I can summarize Krugman's summaries of the European, Latin, and Asian crises in an understandable way without going on for another page. So, I will skip those three pages to the conclusion part.

Krugman then asks at the end whether currency crises can be prevented. The only absolutely sure-fire way he suggests is for countries not to have an independent currency. True monetary union is one answer to the problem of currency crisis (my thoughts: this can never happen cuz it requires a really strong commitment and policy synchronization from every member country. Look at the EMS and how Italy, Spain, and the UK had to drop out of the system in 1992 during the crisis. Countries cannot freely choose expansionary fiscal policy, which could trigger high inflation). In conclusion, Krugman argues that countries should avoid halfway houses: either float the currencies, or join currency unions.