CURRENCY CRISES

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Edward Merkel
Professor
Troy State University

Ever since paper money replaced gold and silver as universal mediums of exchange, investors in foreign currencies have recurrently sold off a nation's money in mass due to the fear that it might be devalued by the issuing government in the immediate future. Ironically, the resulting capital flight out of a currency perceived by investors as being inordinately overvalued would often generate these much feared devaluations. During the twentieth century such financial scenarios played a dominant causative role in the economic turmoil of the interwar period, the dissolution of the Bretton Woods fixed exchange rate system in 1973, and the Latin American debt crisis of the 1980's.

However, economic historians may well dub the 1990's "The Age of Currency Crises." The decade began with massive speculative attacks on the currencies of the European Union (EU) nations which roiled the Exchange Rate Mechanism (ERM), the linchpin of the European Monetary System (EMS), during 1992-93. This resulted in the United Kingdom abruptly withdrawing from the EMS and subsequently delayed the introduction of the Euro until January 1999. This was followed by a 60 percent devaluation of the Mexican peso in December 1994, less than one year after the formation of the North American Free Trade Agreement (NAFTA), which generated an economic tailspin, poignantly referred to as the "tequila" crisis, throughout Latin America during 1995-96. The period 1997-99 produced the Asian financial debacle which initially affected the currencies and economies of Thailand, Malaysia, and Indonesia but then quickly spread, in an adverse fashion of "contagion," to the major economies and currencies of South Korea and Japan. Many of these countries still feel the effects of this crisis in the form of anemic economic growth and chronic unemployment.

The National Bureau of Economic Research, under the editorship of Paul Krugman, has assembled ten papers analyzing the currency crises of the 1990's in this volume. The need to explain both the development of a currency crisis and the impact it has on the world economy is encapsulated in a statement from Krugman's introduction: "Currency crises ... have become a defining force for economic policy in much of the world," p. 1.

The first paper by Barry Eichengreen and Olivier Jeanne, "Currency Crisis and Unemployment: Sterling in 1931," explains the recent 1992-93 EU currency dilemma which culminated with the UK leaving the EMS by presenting parallels to why the UK abandoned the gold standard in 1931. In the next paper, "Political Contagion in Currency Crises," Allan Drazen demonstrates how the political costs incurred by one nation which abandons a fixed exchange rate parity, such as Mexico in 1994 and Thailand in 1997, can be mitigated if neighboring countries follow suit. Thus, the phenomenon of currency flight contagion as seen in the recent "tequila" and Asian financial crises can be predicated on the desire of the governments of developing countries to maintain international credibility. These two papers reaffirm, expand on, and update previous analyses of the causes and results of currency crisis contagion presented by Obstfeld (1994) and Eichengreen, Rose, and Wyplosz (1996).

Giulermo Calvo, in "Balance of Payments Crises in Emerging Markets," and Steve Radelet and Jeffrey Sachs, in "The Onset of the East Asian Financial Crisis," take these issues further by focusing on how unsound financial intermediaries in developing countries engaged in risky loaning practices, in particular the issuance of debt in a strong foreign currency such as the US dollar or the Japanese yen and the granting of loans to politically-connected creditors. The pursuant loss of foreign currency reserves produced classic bank runs that brought down the Mexican peso and the Thai baht. In that the economies of Mexico and Thailand were basically sound, both papers conclude that the "tequila" and Asian crises were thus gratuitous in nature and were caused primarily by incorrect banking practices buttressed by a system of government supported cronymism.

Robert Flood and Peter Garber expand this concept into the developed economies of Europe by pointing out that the success of the Euro, scheduled to replace the currencies of twelve EU nations during 2002, will directly hinge on the soundness and credibility of the European Central Bank. The conclusions drawn in these three papers reinforce similar observations made by McKinnon and Pill (1996) and Chang and Velasco (1998a).

Sebastian Edwards and Miguel Savastano present a thorough analysis of the Mexican peso collapse in "The Mexican Peso in the Aftermath of the 1994 Currency Crisis." By tracing its cause to a peso artificially overvalued by the Mexican government anxious to join NAFTA, they conclude that a currency board for the peso vis a vis the US dollar would have precluded this crisis. On a similar vein, Robert Gordon, in "The Aftermath of the 1992 ERM Breakup," shows that after the UK left the EMS in 1993, the pound appreciated against other European currencies while the currencies which remained in the EMS depreciated against the dollar and the yen. He notes that perhaps, in this case at least, it was "better to fail than succeed at currency defense," p. 251.

Based upon techniques developed in a previous study by Chang and Velasco (1998b), Gian Milesi-Ferretti and Asaf Razin focus on emerging nations by examining a cross-section of currency crises between 1970-99 in "Current Account Reversals and Currency Crises." They prove that while currency...
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crashes are historically correlated with sharp declines in GDP and employment, as with Mexico in 1995-99 and Southeast Asia from 1997 to present, abrupt currency account reversals from deficit to surplus are not. Thus, developing countries need to institute the policies necessary to ensure that macroeconomic stability is in place so as to prevent sudden and sharp currency devaluations and to be less concerned with current account deficits.

The last two papers in this volume by Jeffrey Frenkel and Peter Kenen are the minutes of panel discussions centering on the Asian crisis and the moral hazard created by the IMF bailout.

In conclusion, the decade of the 1990's has produced a major reevaluation of the causes and impacts of currency crises. As more countries link their economies through multilateral trading institutions such as the World Trade Organization, and as regional trade blocs continue to expand, e.g., the EU admission of nations from Eastern Europe and the creation of the Free Trade Area of the Americas in the Western Hemisphere, the contagion effect of the collapse of one currency on others will only escalate. The papers in this volume represent the latest thinking on these crises, "...captured at a moment in which some of the best minds in economics were focused on the theory and practice of speculative attacks on currency," p. 6. In that all nations and their respective citizens stand to gain from freer international trade, it behooves the interested reader to peruse what these "best minds" have to say on a very relevant economic issue.

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