

The three generations of currency crises models



Explain the three generations of currency crises models. What are the implications of the escape clause model?

According to a classification system of International monetary fund we can divide economic crisis to currency crisis, banking crisis, systemic financial crisis, debt crisis. From among these, in words of Jeffrey Frankel, “ we define a currency crash as a depreciation of the nominal exchange rate of at least 25 per cent that is also at least a 10 per cent increase in the rate of nominal depreciation” [1] This crisis is big problem itself because it makes trade condition worse and bring many negative effects to economy of the inside and outside of the country. Not only that but also currency crisis can occasion financial crisis. East Asia’s crisis in 1997 is the case of financial crises which is caused by currency crisis. So for the sake of prevent financial crisis we should know about currency crisis model.

Before 70’s there were also explain model about currency crisis. But krugman’s model realized the theoretical condition of when fixed exchange rate system is collapsed and offered basic paradigm of currency crisis model. So we can define it as a first generation model. In first generation models, it thought economy fundamental’s worse is the origin of currency crisis. Fundamental’s worse example is low growth, insufficiency of foreign currency, budget deficit. More exactly, unsustainable money financed fiscal deficits lead to a persistent loss of international reserves and ultimately ignites a currency crash [2], because people try to sell domestic currency to buy foreign currency. So far as, financial obligations that caused by national bonds issuing is the speculative attack’s root. On the other hand, first generation model’s meaning is government policy need consistency to

control risk of currency crisis possibility. It means fixed exchange rate system can't be sustainable because that policy tries to keep exchange rate (domestic currency's value) without inducing inflation (domestic currency value's fall) by issuing national debt and it is not consistency policy. And it will be controlled by 'invisible hand'. This model has significance that it can explain "middle-south America's currency crisis repetition at beginning of 1980.

But as Obstfeld said, we should argue that one cannot adequately understand recent European currency experience in terms of Krugman's model [3]. From 1992 to 1993, European Exchange Rate Mechanism (ERM) countries suffered fatal currency crisis. Even they had compact and stable fundamental condition. To put it more concretely, in spite of they could obtain funds easily from global finance market and even these countries maintain stability of inflation level crisis happened. So Obstfeld produced 'self-fulfilling crisis model' which can call "second generation model" for explain European Monetary System Crisis, which could not be explained by First Generation Model.

At first generation model, speculation was just accelerator for crisis which will happen sometime or another. But at second generation model suggested a potential for crises that need not have occurred, but that do occur because market participants expect them to. [4] In other words, expectation about government's policy that government will devalue domestic currency induce crisis because they sell currency first. We can imagine this is big sized case of "bank run". So this model indicated speculation can make collapse of currency market and this is the reason why this model is 'self-fulfilling crisis model'. In addition, second generation model indicates the

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situation of multiple equilibrium which means foreign exchange market's equilibrium point when occurs collapse of market is not only one and it can have many point and situation that can cause collapse and it determined by strength of market expectation.

However it doesn't mean the second generation model ignores 'fundamental base'. Because new second model changed there's theory to give weight to 'fundamental base'. This is "Escape clause model". More exactly, it will means currency crisis's reason will be various collate of fundamental fluent and market expectation's strength.

But despite of development of first generation model, second generation model and new second generation model, we can encounter with currency crisis that can't explain by these old models. Mexico and Asia's crisis is one of these cases. They didn't have clearness weakness fundamental base as like dept or inflation. So it cannot explain by first generation model.

Moreover, in this case government's devaluation led recession, not an expansion. So it has problem to explain by second generation model.

So currency crisis model which is focused on reason of recession, especially foreign currency debt is third generation model. With third generation in Asia's crisis, to help private company's foreign loan, governments issued national bonds to prepare subsidy. But it made unexpected happening, value falling of domestic currency and exchange ratio rise. So even same amount in foreign currency, debt became huge value in domestic currency. So government should issue more bonds to solve loan. And it made vicious circle. Finally, government's foreign currency reserve be gone while try to

keep monetary exchange rate even it is going down. And Mexico's case is almost same except someone who is in debt was government.

But interesting point is, some economist suggest that we can explain Mexico and Asia's currency crisis by first generation model or second generation model. It will have same meaning with what 'escape clause model' implies; "All currency crisis will have at least fundamental basic element and 'self-fulfilling fact' . surely and so on. And not only these three model which explained at this essay there are also many kinds of model for explain various types of currency crisis. For example, there are "moral hazard model", "financial panic model", "boom-bust cycle model" etc. I think existence of various types of explain model means there are lots of source for currency crisis. It can be mixed reason also.

Also there will be currency crisis that cannot explain by existing model, because it caused by reason that we could not think or the reason is totally new one. But on the other hand, we should think about fundamental fact and market expectation which is basic fact of currency crisis. With this process, currency crisis model will develop continue.