THE LOGIC OF CURRENCY CRISES

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The dramatic currency crisis that culminated in the August 1993 widening of exchange-rate bands within the European Monetary System (EMS) challenges economists to rethink their models of how markets may force governments to alter supposedly fixed exchange rates. Some European governments, notably Italy's, clearly lacked the full confidence of the markets as a result of fiscal trends incompatible with a fixed exchange rate in the long run. But the scale and scope of the turmoil that began in the summer of 1992 were so great that ultimately even apparently sustainable currency pegs were shaken. The disparate circumstances of the many currencies successfully attacked by speculators has led observers such as Eichengreen and Wyplosz (1993) and Portes (1993) to argue that, at least in the European context, recent speculative crises have been driven in part by self-fulfilling forces.

Economists have rightly tended to be wary of such accounts: finance ministers past and present have preferred to blame crises on Gnomes of Zurich or *agioteurs* rather than face the reality of fundamental factors, including policy errors. A seminal paper by Krugman (1979) provided a convincing theoretical rationale for the economists' view. Krugman set out a simple model in which a currency peg must be abandoned once the pegging nation's foreign exchange reserves run out. He went on to analyze how the peg collapses in situations where the eventual exhaustion of reserves is inevitable. His remarkable finding was that speculators with foresight inevitably attack the currency before reserves are fully depleted and purchase all remaining reserves at that moment—a moment that can be defined precisely. This prediction follows from the simplest principles of currency arbitrage (1).

In this paper I argue that one cannot adequately understand recent European currency experience in terms of Krugman's model. For industrial European countries with access to world capital markets, reserve adequacy *per se* is far less of a concern than it was in the early 1970s; this factor no longer deserves the primacy assigned it in Krugman's analysis (2). Clearly a number of other factors, notably the effects of high interest rates and growing unemployment, came into play in determining how different governments responded to the 1992-93 crisis.

Once one acknowledges that governments may borrow reserves and exercise other policy options in the face of a crisis, the question arises: what factors determine a government's decision to abandon a

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(1) Agénor, Bhandari, and Flood (1992) and Blackburn and Sola (1993) survey the large literature growing out of Krugman's paper.

(2) Under perfect capital mobility, a central bank whose only reason for departing from a currency peg is reserve inadequacy could simply sell domestic assets from its portfolio and attract an equal reserve inflow. This action, which amounts to borrowing reserves with domestic currency, leaves unchanged both the public sector's net debt to the private sector and the national net foreign wealth position. If the peg is in question for reasons other than reserve adequacy, however, the transaction can have strategic implications; see section 2.1 below. Buiter (1987) analyzes a model in which domestic debt issue is more costly than foreign-currency borrowing, so that an open-market sale of domestic debt worsens the public finances.