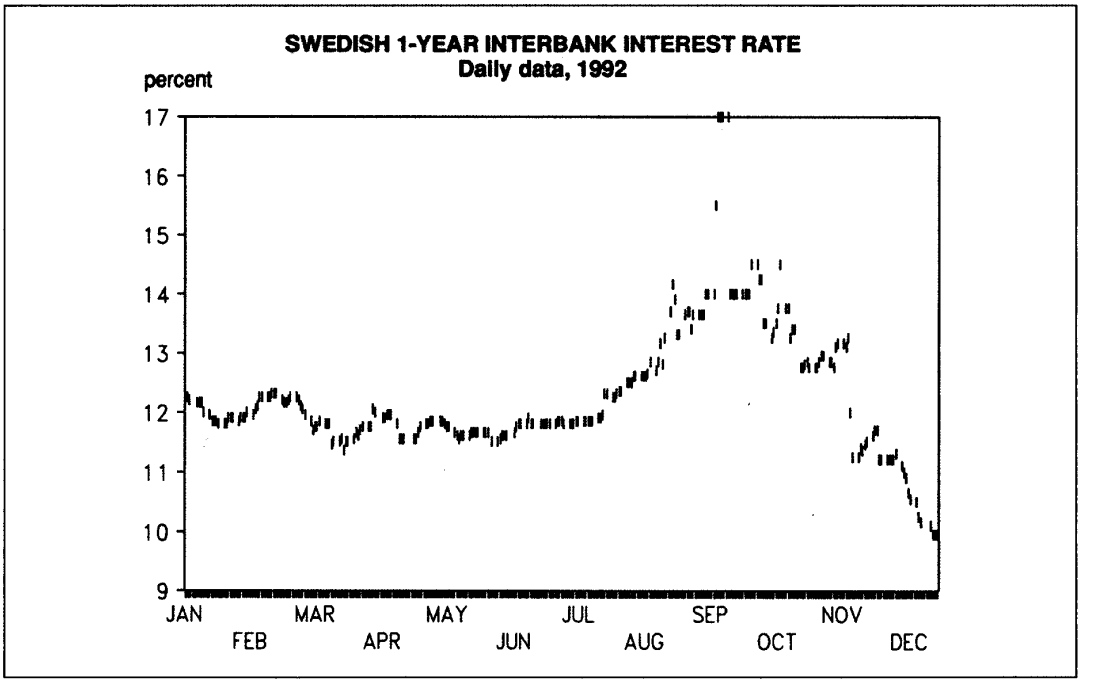
1.3. Evaluation

Models in the spirit of Krugman (1979) provide elegant parables of how rational financial markets respond to unsustainable macroeconomic policies. The models ignore, however, the policy options available to authorities and the ways in which the marginal costs of exercising these options are balanced. Since the actions of rational speculators must be conditioned on the conjectured response of the authorities, the class of models reviewed gives relatively little general guidance on the factors generating crises and determining their outcomes.

Some interesting recent models have offered explicit political underpinnings for models such as Krugman's. Guidotti and Végh (1992) develop a model in which a "war of attrition" over balancing the national budget leads to continuing finance through reserve drains; if agreement is not reached in time, a crisis can occur. Velasco (1993) considers a scenario with divided government in which reserve drains occur because individual ministries fail to internalize the overall public-sector constraint. Stein and Streb (1993) propose an asymmetric-information model in which governments may rationally run down foreign reserves so as to push inflation into the future, thus risking a crisis later. These papers yield important insights into the genesis of crises in countries where fiscal profligacy is the sole underlying cause of currency instability, but they do not cover the entire range of factors at work, particularly in the European context.

Consider, for example, the travails of the Swedish krona during 1992[1]. Sweden announced a unilateral peg to the European Currency Unit in May 1991. The Danish rejection of the Maastricht Treaty on June 2, 1992 was the occasion for a small immediate rise in krona interest rates; these rates rose sharply as uncertainties intensified over the summer (figure 3). The culmination of these developments was an attack on non-EC Nordic currencies in late August and early September, during which Swedish interest rates rose to unprecedented levels. While the krona peg survived this battle, it lost the war soon after, succumbing to a new attack on November 19 and entering a float.

Figure 3



(1) Hörngren and Lindberg (1993) present an excellent review of recent Swedish currency experience.