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# Currency Crises: A Brief Review

# How is the Value of a Currency Determined?

- Floating exchange rate—supply and demand

## ER Rises

exports > imports  
capital inflows

## ER Falls

imports > exports  
capital outflows

- Fixed—central bank maintains exchange rate:
  - buys and sells reserves
  - changes interest rates to attract capital

# There are a Variety of Exchange Rate Arrangements

Commitment

Flexibility

<b>Adopt Another Currency</b>	<b>Currency Board</b>	<b>Fixed ER</b>	<b>Fixed with a Band</b>	<b>“Crawling” Peg</b>	<b>Managed Float</b>	<b>Free Float</b>
Ecuador	Hong Kong	Brazil (’94 - ’99)	EMS (’87 - ’92)	Poland (’92 - 00)	Mexico (’94 + )	U.S.
Euro zone	Argentina (’90’01) Estonia	Poland (’90 - ’92)	Bretton Woods	Chile (1990s) Mexico (’87 - ’94)		Brazil (’99 + )

# Why Fix the Currency?

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## Advantages

Provides stability

Inflation anchor

Visible commitment to  
good policy

## Disadvantages

Limits options

Likely RER rise

Difficult to reverse

# What Causes a Currency Crisis?

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↓ Two factors necessary:

» A fixed exchange rate

» Central bank can't or won't maintain the fixed rate. Options include:

– using reserves, if available

– raising interest rates

