EXCHANGE RATE EXPECTATIONS AND CURRENCY CRISSES

Recall: a fixed exchange rate is enforced in the first instance by exchange market intervention

Central bank balance sheet:

<table>
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<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Foreign exchange</td>
<td>Monetary base</td>
</tr>
<tr>
<td>Bonds</td>
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</table>

The CB trades foreign currency against domestic monetary base to peg the exchange rate

Usually intervention is *sterilized*: if CB takes money out of circulation by buying it on foreign exchange market, it injects an equal amount back in by an open market operation in bonds

E.g.:   FX -100   MB -100 +100 = 0
        B +100
But because FX reserves are limited, eventually monetary base must change; to peg exchange rate expected returns on domestic, foreign bonds must be approximately equal:

\[ i = i^* + \frac{E^e - E}{E} \]

So an increase in expected future exchange rate will require increase in interest rate if current exchange rate is not to change

**CURRENCY CRISIS** (sometimes called “speculative attack”: A country has a fixed exchange rate, but for some reason people begin to suspect that the rate will not remain fixed at current value. This causes loss of reserves and/or forces increase in interest rate, putting pressure on government in fact to devalue the currency. Crucial point is circularity - expectations of collapse of fixed rate regime cause actual collapse, validating expectations.
Currency crises are common in modern world:

1992: Britain, Italy, Sweden

1994-5 Mexico, Argentina (Argentina fought off attack)

1997: Thailand, Malaysia, Indonesia, South Korea

1998: Attack in progress against Brazil