

Currency Crises

The Role of Monetary Policy

IMF STAFF

To counter the speculative attacks on their currencies in late 1997 and early 1998, a number of Asian countries have tightened monetary policy. Although this approach has been questioned by some, experience shows that a period of tight money may be needed to restore exchange rate stability if policymakers fail to act early and forcefully.

DURING the second half of 1997 and in early 1998, a series of speculative attacks caused several Asian currencies—notably, the Thai baht, Malaysian ringgit, Indonesian rupiah, and Korean won—to depreciate sharply. Although these currencies may have been overvalued before the attacks, their depreciation was far greater than any “correction” that might have been

necessary to restore the export competitiveness of the countries in question. What explains the acuteness and persistence of the crisis?

One key explanation is that policymakers failed to address problems in advance of the crisis and did not act forcefully enough when the crisis erupted. Their reluctance either to tighten monetary policy to bolster exchange rates or to keep it sufficiently tight more than temporarily was a particularly important factor contributing to the erosion of investor confidence in the region. The crisis became self-perpetuating.

It is true that, in the short term, tightening monetary policy may exacerbate the difficulties of economies with weak financial systems. But experience has shown that, during a crisis of confidence, the alternative is likely to be worse. An easy monetary policy, by allowing the domestic currency to continue depreciating, undermines confidence and threatens rapid inflation. For countries with substantial debts in foreign currencies, like some of the Asian economies, a steep currency depreciation may undermine the solvency of domestic firms and financial institutions as much as—or even more than—temporary increases in interest rates. And if confidence in a currency continues to erode, a

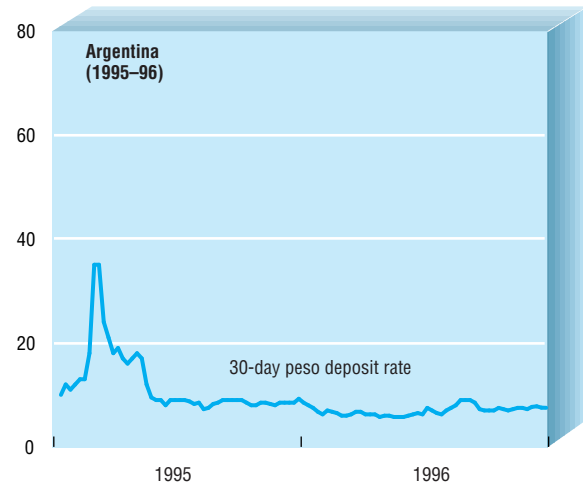
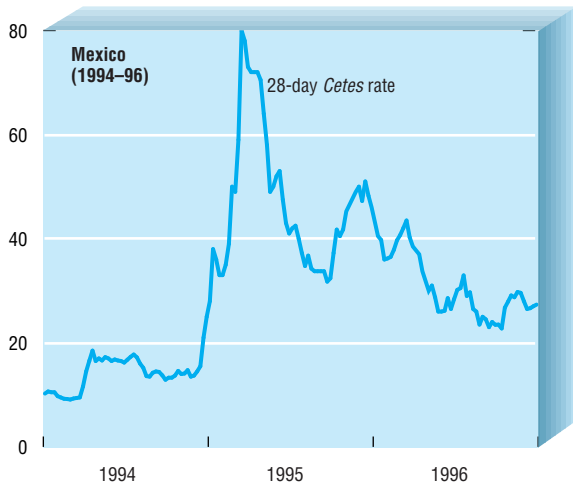
larger and more prolonged increase in interest rates may be required to stabilize the situation than would normally be necessary in the early stages of a crisis.

As the Mexican crisis of 1994–95 and recent experiences in Brazil, the Czech Republic, Hong Kong Special Administrative Region, and Russia have shown, once confidence in a currency has been compromised, a period of sufficiently tight money is necessary, whether to defend a currency peg or to stabilize a flexible exchange rate. How tight varies from country to country.

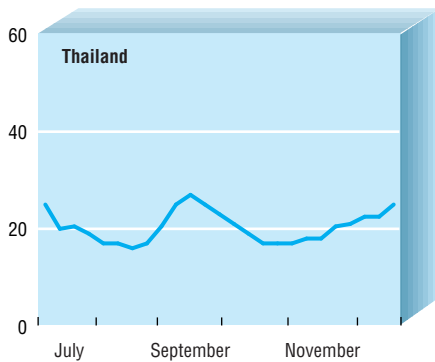
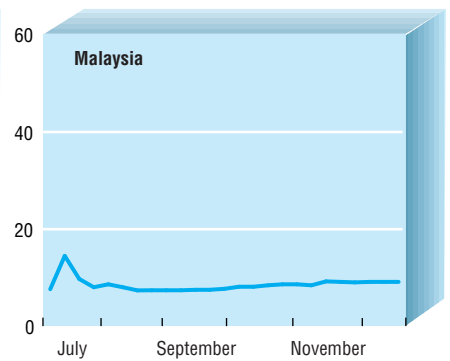
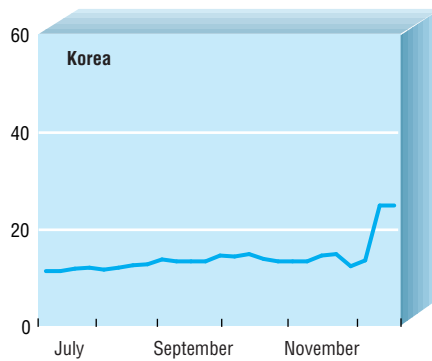
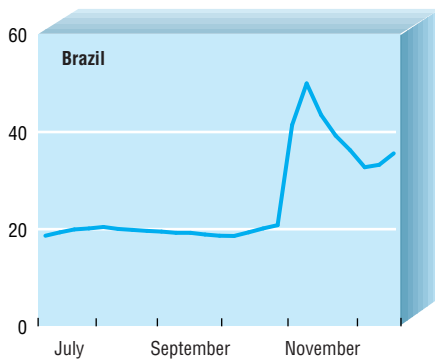
For example, Mexico, because of its history of macroeconomic instability and high inflation, had to allow nominal interest rates on 28-day *Cetes* (peso-denominated government obligations) to climb to 70–80 percent for a few months (see chart). Argentina held to its exchange rate peg during the Mexican crisis; had Argentina abandoned the peg, confidence in its currency would have collapsed. In addition to tightening monetary policy, the two countries addressed weaknesses in their banking sectors, which made it possible for them to survive a period of tight monetary policy without serious damage to their financial systems. They also tightened fiscal policy to reduce current account deficits,

Some countries have allowed short-term interest rates to rise during currency crises to stabilize the exchange rate

(percent a year)

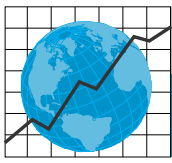


July-December 1997¹



Source: International Monetary Fund, *World Economic Outlook: Interim Assessment*, World Economic and Financial Surveys (Washington, December 1997).

¹ One-month interbank rates except for Korea (15-day interbank rate) and Brazil (30-day deposit rate).



bolster investor confidence, and ensure the availability of funds to cover the costs of restructuring their financial sectors.

In late 1997, Brazil was able to stave off contagion from developments in Asia by acting quickly when it began to have difficulties accessing external financing. First, the central bank doubled interest rates—which were already high. Then, when this move failed to relieve pressures on the *real*, Brazil moved to reassure investors by addressing weaknesses in its public finances; the *real* stabilized, despite continuing turbulence in Asian markets. In the short term, this move will depress domestic demand, but it will also help to reduce Brazil's substantial current account deficit.

In contrast with Brazil, the East Asian economies were not experiencing fiscal problems before the crisis of 1997. Nevertheless, a moderate degree of fiscal

adjustment was appropriate to contribute to the current account adjustments now needed, restore confidence, and cover the costs of financial sector reforms. To defend their currencies against further depreciation, the East Asian economies also needed firmer monetary policies than were implemented in the early stages of the crises. Although Indonesia initially increased interest rates substantially, it lowered them quickly when stresses developed in the banking system; this premature easing contributed to the further decline of the rupiah. Korea, Malaysia, and Thailand were slow to raise interest rates and implemented smaller increases than Indonesia. The Philippines, which took quick action in the face of mounting exchange rate pressures, suffered less of a crisis than its neighbors.

The short-term effect of the policy adjustments required in East Asia would

normally be to slow the growth of domestic demand and, to a lesser extent, of output, as current account deficits are brought into line with reduced external financing inflows. Unfortunately, because the crisis has been prolonged, the slowdown is likely to be greater than it would have been had monetary policy been tightened more forcefully early on. This is the result not of the recommended policy measures, as some critics believe, but rather of the loss of confidence reflecting policymakers' failure to take swift and effective action at an earlier stage, as well as of the unreasoned panic in financial markets. [F&D]

This article is based on Box 5 of the IMF's World Economic Outlook: Interim Assessment, World Economic and Financial Surveys (Washington: International Monetary Fund, December 1997).

What does Asia's crisis mean for the world economy? How accurate are short-term forecasts? How can we measure potential output?

World Economic Outlook: Interim Assessment

A survey by the staff of the International Monetary Fund

The economic and financial crisis that erupted in East Asia in July 1997 deepened and broadened in late 1997 and early 1998. Spillover effects from investors' deteriorating confidence in emerging markets were felt throughout the world. In this special interim assessment, IMF staff present revised economic projections, examine the causes of the crisis and its effect on industrial and developing countries, and outline policy issues.

US\$36.00 (academic rate: \$25.00). Available in English. (paper). ISBN 1-55775-714-3. vii + 72 pp. 1997.

Stock #WEO-EA 0171997.

Staff Studies for the World Economic Outlook

by the Research Department of the International Monetary Fund

This volume contains background papers prepared by IMF staff and visiting scholars for the *World Economic Outlook*. Subjects include the accuracy of the IMF's short-term forecasts, the estimation of potential output, competitiveness indicators, deindustrialization, the effect of globalization on wages, international labor standards and international trade, the design of European Economic and Monetary Union, and prices in transition economies.

US\$25.00 (academic rate: \$20.00). Available in English. (paper). ISBN 1-55775-701-1. v + 149 pp. 1997.

Stock # WEO-EA 0031997

TO ORDER, PLEASE WRITE OR CALL:

INTERNATIONAL MONETARY FUND

Publication Services • Box FD-198 • 700 19th Street, N.W. • Washington, D.C. 20431 U.S.A.

Telephone: (202) 623-7430 • Telefax: (202) 623-7201 • E-mail: publications@imf.org • Internet: <http://www.imf.org>

All orders must be prepaid. American Express, MasterCard, and VISA credit cards accepted.

