Currency Crisis and Stabilization Programme: A Third Generation Approach

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Abstract

A central accompanying feature of financial market liberalization under fully convertible currency was unusual number of severe financial crisis. However, the recent episode of East Asian crisis is considered to be distinctive in several respects. First, it appears to be the first genuinely global financial crisis to hit emerging market economies. Secondly, the Asian crisis appears to be more deeply rooted in financial imbalances in private sector than in the public sector financial problems that characterized the 1980s debt crisis and the Mexican 1994-95 crisis. Thirdly, the crisis involves increasingly dramatic effects. Measured in terms of bank and firm defaults, the costs are enormous. Measured in terms of output and employment loss, the costs are even more frightening. These features of Asian crisis make the third generation approach a relevant framework of analysis. This paper takes credit view of currency crisis as point of departure. In section I we have examined emergence of currency crisis due to rise in risk premium and focused on the macroeconomic adjustment in response to fiscal policy and monetary policy in a hyperdepreciation-led situation of currency crisis under static expectation. We have introduced rational expectation regarding expected depreciation in section II. We have attempted a rational expectation formalization of Krugman’s model (2003) so as to focus on comparative static implications of monetary and fiscal policies in the post-crisis situation.

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I. Introduction

In the wake of the East Asian financial crisis of the 1990s, economists of various persuasions have noted the increasing international mobility of finance capital as a major aspect of the contemporary global economy. It is well known that the volume of international financial transactions far exceeds what is necessary to finance ordinary trade in goods and services and that a very significant share of those transactions is driven by purely financial considerations such as arbitrage opportunities and currency speculation. Moreover, the 1990s marked a shift in the composition of capital flows with a significant increase in net private capital inflow and a decline in the share of official capital flows. It is being increasingly realized that flow of international finance in the form of volatile portfolio investment lies at the root of the recent East Asian currency crisis.

The literature on the theory of currency crisis traditionally distinguishes between first generation and second-generation models.\(^1\) The former focuses on the dynamics of speculative attacks against a currency and emphasizes unsustainable policy stances and fundamental imbalances at the root of the crisis, whereas the latter analyzes the abandonment of an exchange rate peg as a rational choice by an optimizing policy maker and stresses the role of self-fulfilling attack in generating financial instability and currency crisis. Both the approaches do not take into account the role of international capital flows in the generation of currency crisis. Though both the approaches retain their validity depending on the specific forms of a crisis, an alternative approach, known as the third generation approach, though of very recent origin and not fully formalized and structured, can offer a better explanation for crisis and better policy perspective, specifically in the context of foreign currency denominated short term loan characterizing the recent East Asian turmoil.\(^2\)

It is precisely in the context of short run inflow of portfolio capital that a specific third generation approach known as credit view of currency crisis becomes a relevant theme of research in the field of international monetary economics. The

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\(^1\)For first generation models see Krugman (1979). For second generation models see Obstfeld (1994).

\(^2\)For different variants of the third generation approach, see Krugman (2003).