The Return of the Currency Crash

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CAMBRIDGE – Currency-market volatility has been around for decades, if not centuries. Wide gyrations in exchange rates became a staple of international financial markets after the Bretton Woods system broke down in the early 1970s, and mega-depreciations were commonplace later in the decade and through much of the 1980s, when inflation raged across much of the world. Even through much of the 1990s and early 2000s, 10-20% of countries worldwide experienced a large currency depreciation or crash in any given year.

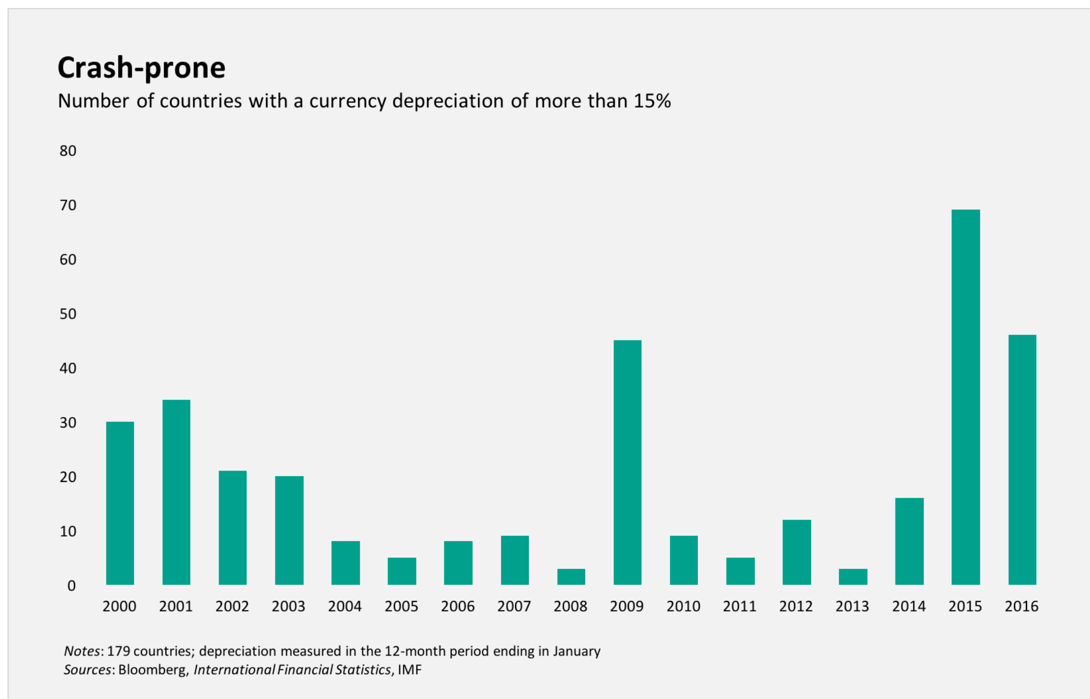
And then, suddenly, calm prevailed. Excluding the mayhem associated with the global financial crisis of late 2008 and early 2009, currency crashes were few and far between from 2004 to 2014 (see figure). But recent developments suggest that the dearth of currency crashes during that decade may be remembered as the exception that proves the rule.

The near-disappearance of currency crashes in the 2004-2014 period largely reflect low and stable international interest rates and large capital flows to emerging markets, coupled with a commodity price boom and (mostly) healthy growth rates in countries that escaped the global financial crisis. In effect, many countries' main concern during those years was avoiding sustained currency appreciation against the US dollar and the currencies of other trade partners.

That changed in 2014, when deteriorating global conditions revived the currency crash *en masse*. Since then, nearly half of the sample of 179 countries shown in the figure have experienced annual depreciations in excess of 15%. True, more flexible exchange-rate arrangements have mostly eliminated the drama of abandoning pre-announced pegged or semi-pegged exchange rates. But, thus far, there is little to suggest that the depreciations have had much of a salutary effect on economic growth, which for the most part has remained sluggish.

The average cumulative depreciation versus the US dollar has been almost 35% from January 2014 to January 2016. For many emerging markets, where depreciations have been considerably greater, weakening exchange rates have aggravated current problems associated with rising foreign-currency debts.

Moreover, in an interconnected world, the effects of currency crashes do not end in the country where they originate. Back in 1994, China reformed its foreign-exchange framework, unified its system of multiple exchange rates, and, in the process, devalued the renminbi by 50%. It has been persuasively argued that the Chinese devaluation resulted in a loss of competitiveness for Thailand, Korea, Indonesia, Malaysia, and the Philippines, which had pegged (or semi-pegged) their currencies to the US dollar. Their cumulative overvaluation, in turn, helped set the stage for the Asian crisis that erupted in mid-1997.



Overvalued exchange rates have been among the best leading indicators of financial crises. So one cannot help but wonder if we are facing a repeat of what happened from 1994 to 1997 – only this time with the roles reversed. Since early 2014, the renminbi has depreciated by a mere 7.5% against the dollar, compared to the euro's roughly 25% depreciation in this period, not to mention even faster currency weakening in many emerging markets. For a manufacturing-based economy such as China's, the overvaluation-growth connection should not be underestimated.

China's announcement last August of its intent to allow modest depreciation and eventually move the renminbi toward greater exchange-rate flexibility triggered a roller-coaster ride in financial markets. To provide reassurance, policymakers issued statements to the effect that China would move only gradually in that direction. But perhaps the cautionary tale from the Asian crises is that gradualism on this front carries its own risks.

Of course, the potential beggar-thy-neighbor effects of the spike in currency crashes in the past two years are not unique to China. They may also apply to any country that has maintained a comparatively fixed exchange rate (a category that includes major oil producers).

What distinguishes the Chinese case from others is the sheer size of its economy relative to world GDP, as well as its effects on numerous countries across regions, from suppliers of primary commodities to countries that depend on Chinese funding or direct investment. The broader point is a simple one: Emerging markets now account for around 60% of world GDP, up from about 35% in the early 1980s. Restoring global prosperity requires a much broader geographical base than it did back then. The return of the currency crash may make achieving it all the more difficult.