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## Coordination, cooperation, contagion and currency crises

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### Abstract

We present a micro-founded model where governments have an incentive to devalue to increase the national market share in a monopolistically competitive sector. Currency crises generated by self-fulfilling expectations are possible because workers demand high wages when they expect a devaluation. This decreases the competitiveness and profits of national firms and induces the government to devalue. We show that the more important trade competition, the more likely self-fulfilling speculative crises and the larger the set of multiple equilibria. Coordination decreases the possibility of simultaneous self-fulfilling speculative crises in the region and reduces the set of multiple equilibria. However, regional coordination, even though welfare improving, makes countries more dependent on other countries' fundamentals so that it may induce more contagion. © 2001 Elsevier Science B.V. All rights reserved.

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### 1. Introduction

Recent currency crises, such as the 1992–1993 EMS crisis, the crash of the Mexican Peso in 1994 and its Tequila effect on other countries, as well as the

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Asian crisis, have involved several countries in the same geographical region. Most recently, the Asian crisis broke out in Thailand in May 1997, but spread rapidly to Malaysia, the Philippines, Indonesia and South Korea. In the European case, contagion was also important as the crisis hit five countries (Finland, the UK, Italy, Sweden and Norway) in its first year. By 1993 all countries except Netherlands had to widen the band of fluctuation with the DM. The attack on the peso was itself followed by attacks on several Latin American countries.

Despite the fact that currency crises typically involve several countries that fix their currencies either to the dollar or to the DM, existing models of currency crisis look at the problem in a two country framework where the actions of the country that pegs its currency are key.<sup>1</sup> This is the case of models of the ‘first generation’ type (Krugman, 1979), where the crisis comes with a run on the Central Bank’s reserves, because speculators understand that monetary authorities conduct a policy inconsistent with the fixed parity. This is also the case with ‘second generation’ models (Obstfeld, 1991), which consider devaluation as an intentional decision of a government, that weighs advantages and disadvantages: the cost of opting out of the fixed exchange rate system is primarily considered as a political cost; as for the cost of staying in, it can be modeled as high interest rates<sup>2</sup> or as unemployment.<sup>3</sup>

As argued by Glick and Rose (1999), ‘from the perspective of most speculative attack models, it is hard to understand why currency crisis tend to be regional’. They argue that trade linkages should be first among the suspects for explaining regional contagion of currency crises and give strong empirical support to this channel using five different crises. Eichengreen et al. (1996), in an empirical study using 30 years of panel data from twenty industrialized countries, also conclude in favor of a stronger explanatory power of international trade linkages than of macroeconomic similarities. Even though not modeled explicitly by these authors, the role of trade linkages is that in the presence of price rigidities a devaluation brings a short term competitive advantage to the country that devalues and therefore increases the cost for trade partners not to devalue.

The existence of these spillovers raises the issue of international cooperation: if governments take into account the negative externalities of devaluation on other countries, it might be easier to stop the snowball, perhaps even before it starts. Actually, some steps had been taken before the outbreak of the Asian crisis

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<sup>1</sup>Exceptions are Gerlach and Smets (1994), Masson (1998) and Buiters et al. (1995, 1998).

<sup>2</sup>See, for example, Obstfeld (1996) or Ozkan and Sutherland (1994).

<sup>3</sup>See for example Bensaid and Jeanne (1997) or Drazen and Masson (1994). For empirical evidence on the role of self-fulfilling speculation in currency crises, see Jeanne (1997).

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