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Recovery from a currency crisis: some stylized facts

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Abstract

Using a comprehensive data set of over 100 developing countries, this paper examines how economies recover from a currency crisis. Some of the regularities found are listed below. First, it takes less than 3 years for the GDP growth rate to fully recover its tranquil-period average. The level of GDP, however, remains permanently below its initial trend, suggesting that the shocks underlying a crisis are persistent. Second, the credit crunch problem lasts much longer than the reduction in the GDP growth rate. Third, the pre-crisis credit expansion and reserve inadequacy, which have been widely recognized as the main causes of a crisis, also are closely related to the extent of the post-crisis recession. Fourth, crisis episodes that are caused mainly by illiquidity, rather than by insolvency, tend to exhibit a sharp recovery.

JEL classification: F34; O16
Keywords: Currency crises; Insolvency; Illiquidity; Recovery

1. Introduction

The goal of this paper is to examine how economies evolve after the eruption of a currency crisis. Since the Tequila and Asian crises, there has been a resurgence of interest in currency crises. However, most of the studies on currency crises examine the causes of a

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crisis, and the issue of what happens after a currency crisis still remains relatively unexamined. How long does it take for the economy to fully recover from a crisis, and which economies recover faster than others? This paper aims to answer these questions by providing some stylized facts about macroeconomic adjustment of crisis-hit economies.

Some of the previous studies on currency crises documented how various macroeconomic indicators evolve before and after a crisis (Eichengreen et al., 1995; Aziz et al., 2000; Frankel and Rose, 1996). These studies focused on the causes of a crisis, however, and only briefly examined the aftermath of the turbulence. Among the existing studies that looked more directly at the post-crisis adjustment, Bordo et al. (2000) examined the average duration and the severity of a currency crisis. However, this study only investigated the variation in the recovery process over time (between the pre-1973 and the post-1973 periods) rather than the variation between countries. In addition, while Gupta et al. (2001) and Lee and Park (2001) examined the cross-country differences in the pace of recovery, their results are likely to be biased because of the endogeneity problem. Gupta et al. (2001) used the difference in the GDP growth rate between three pre-crisis years and two post-crisis years as a measure of the pace of recovery (the dependent variable) and various macroeconomic indicators in the three pre-crisis years as the explanatory variables. Thus, what they estimated out may be simply the correlation between the explanatory variables and the pre-crisis GDP growth.[1] Lee and Park (2001) estimated an equation that relates the GDP growth rate in post-crisis years to contemporaneous macroeconomic indicators.

In this paper, using a comprehensive data set of roughly 100 developing countries, we re-examine the macroeconomic adjustments in the aftermath of a currency crisis. In particular, we choose our variables so that the possibility of the aforementioned endogeneity problem is reduced. Additionally, unlike most previous studies, we pay special attention to possible outliers in the data. We believe that careful treatment of outliers is particularly important in analyzing a data set from many developing countries.

The main findings of this paper are listed below. First, although GDP growth falls initially after a crisis, it fully recovers its tranquil-period average in less than 3 years. This suggests that the effects of a currency crisis on growth are not as persistent as is often believed. The level of GDP, however, tends to be permanently lowered by a crisis since the growth rate in the post-crisis period does not exceed its tranquil-period average. A "technical rebounding" or return to the initial growth path is not a common occurrence in our data. Second, the credit crunch problem is much more persistent than the reduction in the GDP growth rate. The real credit growth, for instance, does not show any clear improvement over the post-crisis years that we consider. Third, the extent of the investment/lending boom and reserve inadequacy in the pre-crisis period is important for the pace of post-crisis growth. Existing studies have reported that the extent of domestic credit growth and the relative magnitude of the short-term debt and liquid assets are two of the most robust indicators of a future currency crisis. We find that these factors are important in determining the pace of post-crisis growth, as well. Among the two factors,

[1] For example, the pre-crisis capital inflows and the pre-crisis economic boom (main explanatory variables in their regressions) are likely to be highly correlated with the pre-crisis GDP growth.