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Are Crisis-Induced Devaluations Contractionary? If so, Why?¹

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4.1 Introduction

The Mexican crisis of 1994–1995 followed by the East Asian crisis of 1997–1998 and the other crises in Brazil, Russia and Turkey in 1999–2000 have generated a great deal of academic and policy interest in the causes of currency crises in emerging and developing economies. The main focus of this literature has been on whether the crisis was “inevitable” (first generation models) or “self-fulfilling” (second generation models). A common element in both these two genres of crisis models is that, if a speculative attack is successful in breaking down the currency peg, the resulting devaluation ought to mark the end of the crisis. Real devaluation, according to the conventional view, would have expansionary effects because it increased the demand for tradables (Dornbusch 1988). In practice, the postdevaluation experiences have varied markedly among countries. Some countries, like Brazil, seemed to recover smartly following the initial devaluation of the real. Others underwent a considerable output contraction immediately following flotation of the respective currencies. Kamin and Rogers (2000) and Santaella and Vela (1996) confirm this (contraction) to have been the case for Mexico following the 1994–1995 crisis and Moreno (1999) shows it to have held for East Asia in general.²

In view of the above, Dooley and Walsh (2000) have commented, “(w)e are unsure why some crises are followed by long periods of economic recession while others are not” (p. 3). This chapter is an attempt at answering this query. In particular, we investigate two closely related issues. We first explore whether there is a difference in the output effects of a devaluation during “normal” periods versus crisis ones; after all, during non-crisis periods, real exchange devaluation is seen as an important policy option for promoting exports and output growth.³
Yet, the literature has not made a distinction between crisis and non-crisis periods. To preview the main conclusion, we find that the contractionary effects tend to exist only during the crisis period. Building on this, we go on to explore the factors that cause a crisis-induced devaluation to be contractionary.

The remainder of this chapter is organized as follows. Drawing upon recent analytical literature on currency crises and capital flows, the next section synthesizes the reasons for and channels via which a devaluation is contractionary. This section outlines the specific hypotheses to be tested. Sections 4.3 and 4.4 respectively describe the econometric model and the data to be used in the analysis. The main results are summarized in Section 4.5. The final section offers a summary and a few concluding remarks.

4.2 Devaluation in emerging and developing economies: contractionary channels

4.2.1 New structuralist school: current account channels

There exists a rich early literature that has detailed the various channels through which a devaluation might be contractionary in emerging and developing economies due to their unique economic structures, a point stressed by the so-called “New Structuralist” school (Taylor 1981). There are various well-established routes via which devaluation may, in principle, have a contractionary effect that spans both aggregate demand and aggregate supply (see the well-cited papers by Edwards 1989; Lizondo and Montiel 1989 and van Wijnbergen 1986 for comprehensive reviews; Cooper 1971 provides one of the earliest systematic surveys).

On the demand side, and with both a high average propensity to import and a low price elasticity of demand for imports, devaluation will tend to divert domestic monetary demand away from home produced goods. The income redistributive effects of devaluation will favour profits in the traded goods sector—the mechanism through which devaluation affects the current account—and disfavour real wages, as the price level rises. However, spending and savings propensities may differ as between those receiving profits and wages. If the marginal propensity to save is higher from profits than from wages the economy’s average propensity to save will rise and this will tend to be demand contractionary (Diaz-Alejandro 1963 and Knight 1976). On the supply side, there are again a number of channels through which devaluation may exert a recessionary impact. To name one, the domestic currency costs of imported inputs will rise, leading to stagflationary effects.