The Determinants of Currency Crises, A Political-Economy Approach, 
Björn Rother 
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Currency crises are an elusive phenomenon. At times, all signs point to a storm, yet nothing happens, and at other times the ocean is flat but a crisis hits out of the blue sky. Rother appears to sympathize with Kindleberger’s beautiful “one knows a financial crisis when it happens” but he is up to more, indeed much more. Convinced that in addition to economic fundamentals politics play a decisive role in the evolution of currency crises he sets out to develop and then to test a political-economy model of a crisis predictor that may serve as an early warning system.

As a warm up the book starts with a very readable and interesting history of four major currency crises, the British and French abandonment of the link to gold in the 1930s, the Turkish crisis at the start of this millennium, and the decline and eventual collapse of the Argentinean currency board system that culminated in a bold debt moratorium and the end of convertibility in early 2002. One cannot but agree that in all of these political turmoil unsettled investors and helped trigger the crises.

The following chapter is devoted to carefully identifying and analyzing the political factors that may lessen the willingness to maintain a currency peg. Rother is apparently not a fan of first generation models in which incompatible domestic policies eventually end in a crisis, nor of the contagion type where a crisis may occur despite sound macroeconomic policies. He develops a second generation model in which the government, the governor, or both decide on the basis of a goal function. Rother models this in the form of a quadratic loss function in the deviations from a target exchange rate change of zero and a target level for real output. There are two problems with this approach. First, it is not self-evident that a peg is a wise choice because that means to forego the cushioning effect a flexible exchange rate may have on domestic and foreign shocks. And secondly, the quadratic nature of the loss function implies that politicians value not only unwelcome but also welcome deviations negatively. However, quadratic loss functions are standard in this type of literature because they permit explicit solutions. Rother exploits this advantage to its

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fullest by exploring and comparing an impressive array of political aspects including the effects of credibility, cheating, commitment, election horizons, length of periods in office, fiscal veto players, intra-government conflicts, blackmailing of the central bank by the fiscal policy maker, and lobbying. This entire chapter is nicely self-contained, and at its very start where the pace is perhaps a bit too fast for the general reader with a rusty knowledge of modern macro, an appendix is offered.

After a brief survey of recent empirical studies on the political economy of currency crises Rother then sets out to test his model on a large data sample. To identify an upcoming crisis he relies on an additive pressure index in the rate of depreciation and the loss of reserves per month, both normalized on their respective standard deviations. A crisis is deemed imminent if this pressure index exceeds the sum of its 24 months mean plus n times its standard deviation with the crisis indicator being labelled weak when n=2 or strong when n=3. After various equality of means tests for economic and political variables in crisis as against no crisis periods Rother then tests the explanatory power of key economic variables on the basis of a logit model, first excluding and later including the set of relevant political variables. The results are disappointing. As one might expect, the real exchange rate, the ratio of broad money over reserves, and the number of years elapsed since the last crisis turn out to be highly significant in virtually all runs, but the political variables which turn out to be significant for the weak crisis indicator specification cease to be so for the strong indicator, and vice versa. Still, the political variables make a small difference when it comes to predicting crises within the data sample. Inclusion of these variables raises the number of correctly identified crises slightly and reduces the number of false alarms somewhat compared to the economic baseline specification, but that is a cold comfort.

The bottom line is then that it is economic fundamentals which trigger currency crises and that purely political aspects play a marginal role at best.