

Emerging Market Currencies. Defend or Debase?

In this time of emerging market capital flight, governments may be tempted to defend their currencies. This is a mistake. Such a defense rarely works. As governments buy local currency and sell hard currency, foreign reserves are further depleted signaling weakness to speculators who are encouraged to further short the currency. This establishes a death spiral. A better strategy, albeit a rather frightening one, is for governments to join in the carnage and sell local currency for hard currency. This drives the currency down improving the terms of trade and export competitiveness. In the short term it boosts reserves, and in the longer term, it boosts reserves.

There are of course, risks, to this strategy. The currency could depreciate too quickly. Governments have to stand ready to close the capital account in that eventuality. The alternative tends to lead to the same conclusion anyway.