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International Protection

Pros and cons of high interest rates against speculative attacks

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Pros and cons of high interest rates against speculative attacks

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To fend off speculative attacks, a first line of defense for the central bank is to raise interest rates to impose a squeeze in short sellers of the domestic currency. This interest rate defense is designed to raise the finance cost to speculators, prior to a possible devaluation, above their anticipated capital gains in the event the devaluation indeed takes place –a situation that might force an eventual closing of the short positions.

However, the interest rate defense may not be effective if sophisticated financial instruments are used by speculators. Moreover, the potential costs of maintaining high interest rates in periods of heavy speculative currency pressures can also be high. In particular, the interest costs of a squeeze are imposed both on speculators and on agents who are short in the currency for commercial reasons; thus high interest rates will over time affect economic activity. If these costs are large, the central bank may not be able to convince agents of its commitment to defend the fixed exchange rate.

The perception of financial fragilities may have led speculators to believe that pegged exchange rate regimes in several countries of the region could not be defended very long with high interest rates –because of their adverse effect on bankruptcy rates and nonperforming loans- and thus led to persistent pressures on foreign exchange markets.

For instance, in 1994 Brazil launched an ambitious stabilization program, the Real Plan. The plan was successful in achieving very rapidly single-digit inflation. However, stabilization was accompanied by strong domestic demand growth and an appreciation of the real exchange rate, which forced the authorities to keep real interest rates at pretty high levels. In turn, by increasing debt service payments, high interest rates contributed to a sharp deterioration in fiscal accounts.

In late 1997, growing fiscal and external imbalances led to a first wave of speculative pressures following the Asia crisis. High interest rates and a relaxation of capital account restrictions led to renewed inflows of capital in early to mid-1998, which helped rebuild international reserves.

The persistence of fiscal weaknesses and growing perceptions of external vulnerability, together with the general adverse effects of the Russian default in August 1998 on private capital flows to developing countries, led to renewed speculative pressures on the exchange rate in the second half of 1998. The authorities responded by intervening heavily in the foreign exchange market and by increasing interest rates sharply.

Also is very important, the time when the policymakers increase the interest rates.

For instance, in the 1997 Thai Baht Crisis, the Bank of Thailand tightened significantly its monetary policy stance and increased interest rates only after the currency had collapsed and after a continuing period of depreciation. Unfortunately, the timing of the policy change did nothing but aggravate the financial situation of domestic firms, because the depreciation had already increased sharply the domestic-currency value of their foreign-currency liabilities. A sharp fall in domestic credit was accompanied with a fall in output, as well as an increase in the bankruptcy rate and the proportion of nonperforming loans (from about 15 percent to 25 percent) –which further weakened an already fragile banking system.

The real interest rates are also predictors of banking crises, because rises in domestic real interest rates, and adverse movements in output, often lead to an increase in the rate of default on bank loans. Demirgüc-Kunt and Detragiache (1998) found that banking crises during the period 1980-94 tended to erupt when growth is low, and inflation and real interest rates are high.

Finally, interest rates have an equilibrating role that eliminates the incentive for a run on reserves. For instance, if the public anticipates a devaluation, it will shift out of domestic money. The authorities may accommodate the public by bond sales as interest rates that reflect these expectations; such bond sales avert the need to shift into foreign assets. So, the implication of this analysis is that without capital controls interest rates are likely to display substantial variability.