

loose control over its monetary policy. It could still use fiscal policy as a tool to achieve its macro-economic goals. Fiscal policy measures, however, do not have the flexibility of the monetary policy to respond quickly and effectively to changes in macro-economic conditions. Consequently, a full commitment to permanently-fixed exchange rates would severely restrict a country's capability to deal with its macro-economic conditions.

Most countries would be unwilling to give up the use of monetary policy in order to single-mindedly pursue the goal of pegged exchange rates. A country can gain some monetary independence by allowing an occasional adjustment in the pegged exchange rate (via a devaluation or a revaluation). However, the option of an adjustable peg seriously undermines the credibility of a permanently fixed exchange rate regime and makes the regime vulnerable to a speculative attack.

A speculative attack on a currency is based on an expectation that it will be devalued. To maintain the price of the currency in face of such an attack, the country must be willing to sharply increase its short-term interest rates to offset capital gains expected from devaluation by speculators. If the country is not willing to follow this course because of concerns about negative effects of high interest rates on the economy, then international reserve losses will force the country to devalue the currency, usually by a large amount. A large devaluation would also have undesirable effects on the economy. Thus, speculative attacks cause a serious policy dilemma for an adjustable-peg regime.

A number of models have been developed to explain speculative attacks. One approach views these attacks as arising from inconsistencies between the behaviour of economic fundamentals under a policy regime and the fixed level of the exchange rate.⁶ While this approach focuses on the inconsistencies of a policy regime, another approach emphasizes the self-fulfilling nature of currency crises. For example, suppose that a country experiences a run on its currency simply because of a

⁶ The basic models in this approach have been developed by Paul R. Krugman, "A Model of Balance-of-Payments Crises", *Journal of Money, Credit and Banking*, 11, August 1979, 311-25; and Robert P. Flood and Peter M. Garber, "Collapsing Exchange-Rate Regimes: Some Linear Examples", *Journal of International Economics*, 17, August 1984, 1-13.