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Fundamental pitfalls of exchange market pressure-based approaches to identification of currency crises

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Abstract

This study seeks to demonstrate that the identification of crisis episodes based on commonly applied exchange market pressure (EMP) indices, namely, Eichengreen, Rose and Wyplosz [Eichengreen, B., Rose, A., and Wyplosz, C., 1995, Exchange Market Mayhem: The Antecedents and Aftermaths of Speculative Attacks, *Economic Policy* 21 (October), 249–312.], Sachs, Tornell and Velasco [Sachs, J.D., Tornell, A., and Velasco, A., 1996, Financial Crises in Emerging Markets: The Lessons From 1995, *Brooking Papers on Economic Activity* 1, 147–215.], and Kaminsky, Lizondo and Reinhart [Kaminsky, G., Lizondo, S., and Reinhart, C., 1998, Leading Indicators of Currency Crises, *IMF Staff Paper* 45, 1 (March), 1–48.] are highly sensitive to the choice of: a) the weighting scheme for each component of the EMP index; and b) the statistical parametric assumption used in the constructions of crisis thresholds. To highlight

further some of the potential consequences of these two pitfalls in identifying crisis episodes, this paper employs a number of possible alternative approaches to measure the exchange market pressure.



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Currency crisis; Exchange market pressure; Extreme Value Theory; East Asia; Latin America

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