A speculative attack is a **sudden, massive sell-off of a country's currency** in the foreign exchange market, often targeting countries with fixed exchange rates or pegged currencies. **Speculators**, either domestic or foreign, believe the currency is overvalued or unsustainable, and they sell it in an attempt to depreciate its value and profit from the resulting price difference.

- **Fixed Exchange Rates:**

  A speculative attack often targets countries that maintain a fixed exchange rate or peg their currency to another (e.g., Hong Kong Dollar pegged to the US Dollar).

- **Overvaluation:**

  Speculators might believe the fixed exchange rate is unsustainable, either because it's too high or because it doesn't accurately reflect the country's economic fundamentals.

- **Selling Pressure:**

  Speculators sell large quantities of the target currency in the foreign exchange market, putting downward pressure on its price.

- **Central Bank Intervention:**

  To defend the fixed exchange rate, the country's central bank typically intervenes by buying its own currency to keep the price at the pegged level.

- **Depletion of Reserves:**

  If the attack is strong enough, the central bank's foreign currency reserves may be depleted, potentially leading to a devaluation of the currency.

- **Profit for Speculators:**

  If the currency devalues (or if the pegged rate is abandoned), speculators who sold the currency can profit from the price difference.

- **Examples:**
  Speculative attacks have historically occurred against currencies of countries with high capital mobility and fixed exchange rates, as well as in countries with perceived economic or political instability.
  - In essence, a speculative attack is a coordinated effort by investors to destabilize a currency by selling it heavily, often in the hope of forcing a devaluation or collapse of the fixed exchange rate regime

Definition

Speculative attacks refer to a situation where investors or speculators deliberately target a currency or asset, attempting to profit from its expected decline in value. These attacks can put significant pressure on a country's exchange rate policy, often leading to currency devaluations or the abandonment of fixed exchange rate regimes.

1. Speculative attacks often target countries with fixed or managed exchange rate regimes, as these are seen **as more vulnerable** to currency crises.
2. Speculators **may sell the targeted currency short**, **betting on its decline**, **or engage in other trading strategies to profit from the expected depreciation**.
3. Successful speculative attacks can force a country to abandon its fixed exchange rate and allow the currency to float freely or devalue it to a new, lower level.
4. *Speculative attacks can have significant economic consequences, including higher inflation, reduced economic growth, and increased financial instability*.
5. Governments and central banks may attempt to defend their currencies against speculative attacks through interventions in the foreign exchange market or by raising interest rates.

A fixed exchange rate will be the victim of speculation if:

1. **The currency is at the wrong market value**. e.g. in 1990, the UK arguably joined at a rate that was too high. (The economy was experiencing high inflation and an economic slowdown, meaning the value of the currency was too high)
2. **The Government doesn't have sufficient reserves to protect the currency**. In practice, government reserves are only a fraction of the value traded on foreign exchange markets. The old saying is 'you can't buck the market' If a country can rely on other Central Banks to intervene they have more potential.
3. **People have no confidence in the government intervention**. For example, the day before the UK left the ERM, the government increased interest rates to 15% in a desperate attempt to prevent the value of the currency falling. Usually, high-interest rates increase the value of the

exchange rate. However, they were unsuccessful. Speculators correctly predicted that these high-interest rates just couldn't be maintained when the economy was in recession. Therefore it was an empty move.

Factors Leading to the Speculative Attack

In order to fully comprehend the intricacies of a speculative attack, it is essential to delve into the factors that contribute to its occurrence. *Speculative attacks*, such as the one that took place on *Black Wednesday*, can have far-reaching consequences on a country's economy and financial stability. Understanding the underlying causes of these attacks can shed light on the motivations behind such actions and provide insights into *potential preventive measures* that can be taken in the future.

1. *Economic Vulnerabilities*: One of the primary factors leading to a speculative attack is the presence of economic vulnerabilities within a country. These vulnerabilities can manifest in various forms, such as high inflation rates, large fiscal deficits, or unsustainable levels of public debt. For instance, in the case of *Black Wednesday*, the United Kingdom faced *significant economic challenges*, including high inflation and a widening current account deficit. These vulnerabilities made the British pound susceptible to speculative attacks, as investors sought to take advantage of *the weak economic fundamentals*.

2. Exchange Rate Pegs: Another crucial factor that can contribute to a speculative attack is the presence of an exchange rate peg. When a country fixes its currency to another currency or a commodity, it is essentially making a commitment to maintain a specific exchange rate. However, if market forces and economic conditions are not aligned with the peg, it can create a mismatch that attracts *speculative activity*. For example, prior to Black Wednesday, the British pound was pegged to the European Exchange Rate Mechanism (ERM), which aimed to stabilize *exchange rates* within a narrow band. However, the pound's value was overvalued relative to *its economic fundamentals*, making it an attractive target for speculators.

3. market Sentiment and expectations: *Speculative attacks* are often driven by market sentiment and expectations. If investors perceive a currency to be overvalued or anticipate a devaluation, they may engage in *speculative activities* to profit from the expected depreciation. This can create a self-fulfilling prophecy, as increased speculation can put pressure on the currency, leading to its devaluation. In the case of *Black Wednesday*, *market sentiment* played a significant role, as rumors of *an imminent pound devaluation* circulated, prompting speculators to sell the currency and exacerbating *the downward pressure* on its value.

4. Lack of Central Bank Credibility: The credibility and reputation of a country's central bank can also influence the likelihood of a speculative attack. If investors perceive the central bank to have limited resources or a lack of commitment to defending the

currency, they may be more inclined to engage in speculative activities. A loss of confidence in the central bank's ability to maintain the exchange rate can further fuel speculative attacks. In the context of Black Wednesday, the Bank of England's limited foreign exchange reserves and perceived lack of determination to defend the pound eroded *market confidence*, making the attack more likely to succeed.

5. Global economic and Political factors: Speculative attacks can also be influenced by global economic and political factors. For instance, changes in global interest rates, trade tensions, or geopolitical events can create an environment conducive to currency speculation. In the case of *Black Wednesday*, the attack was partly triggered by the Bundesbank's decision to raise interest rates, which put pressure on the pound within the ERM. Additionally, *political considerations*, such as the desire to maintain the stability of the ERM amidst *European integration*, also played a role in shaping the events leading to the attack.

Understanding the factors leading to a speculative attack can provide valuable insights into the dynamics of financial markets and the vulnerabilities that can expose a currency to speculative pressure. By recognizing these factors, policymakers can take preemptive measures to address economic vulnerabilities, strengthen central bank credibility, and ensure the stability of exchange rates, thereby mitigating the risk of *future speculative attacks*. Ultimately, a comprehensive understanding

of these factors can contribute to the development of *more resilient and stable financial systems*.

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Speculative Attacks, Forward Market Intervention and the Classic Bear Squeeze

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In a speculative attack, when agents believe that a currency will be devalued in the near future, the strategy followed, to hedge against this currency or to speculate against it, is to go short in the currency.[8] Once the exchange rate is abandoned, a profit can be realized by unwinding the short position at the new (cheaper) post-collapse rate.

The most common form of speculative position-taking is by means of forward contracts.[9] This is an off-balance sheet item for banks, and whenever speculators see a deviation of the market forward rate from their expectation of the future spot rate, they buy forward contracts to deliver the weak currency in the future. Banks, as market-makers, will be the counterparty to such position-taking. However, banks—due to prudential regulations imposed on them and/or their risk-aversion—try to offset the currency and maturity mismatches acquired as a result of their market-making activities. They balance their currency and maturity positions by writing off-setting forward contracts (real or synthetic) with other counterparties, but since the banking system as a whole attempts to do the same, the ultimate counterparty is the central bank as it is the only market participant willing to buy the weak currency in the future. Given certain expectations of the extent of central bank intervention—and hence banks' ability to balance their positions—banks limit their positions with speculators.

An alternative form of position-taking is by borrowing the weak domestic currency, selling it for the strong currency, and placing the funds in a bank deposit. If the domestic currency then depreciates, the speculator can unwind the position and make a profit. This set of transactions is on-balance sheet, and therefore requires the use of bank reserves. It is therefore inherently more expensive than an off-balance sheet item such as forward contracts. This strategy is therefore less preferred and is only undertaken once forward markets have been saturated.

For holders of domestic-currency denominated assets, a third form of speculation is to switch to foreign denominated assets until the currency has collapsed, and then switch back to the domestic currency assets. Such liquidation of positions has been known to have occurred in the EMS crisis of 1992 (IMF (1993), pp.42-43), but this is not pure speculation to the extent that such actions are taken by agents already holding assets in the domestic currency.

In summary, it is known that the primary form of position-taking in a speculative attack is through forward markets. On-balance-sheet strategies become important if the forward markets dry up, as such strategies are costlier.

Central banks can intervene in the forward markets or in the spot markets. If net forward positions taken by the speculators and the banking system against the currency are exactly matched by an equal number of off-setting forward contracts offered by the central bank, then all positions cancel each other out and there is no need for spot intervention. If, however, the central bank does not intervene fully in the forward market, then activity spills over to the spot market and the central bank will have to undertake sterilized spot market intervention to balance the net short positions taken against its currency.[10]