

SPECULATIVE ATTACKS



vEcoSys

SPECULATIVE ATTACKS



We have all heard of Financial speculation, which involves the buying & selling of stocks, bonds, currencies, real estate or any other valuable financial instrument *owing to anticipated fluctuations in its price with the aim of profiting from it.*



SPECULATIVE ATTACKS

Simply put...

- **Financial Speculation is the process of selecting investments with higher risk in order to profit from an anticipated price movement.**
- **Speculation should not be considered purely a form of gambling, as speculators do make informed decisions before choosing to acquire the additional risks. In that sense, it is a positive, though risky, form of investing.**
- **But speculation cannot be categorized as a traditional investment because the acquired risk is higher than average.**



SPECULATIVE ATTACKS

So what *are* Speculative Attacks?

A Speculative Attack, on the other hand, refers to massive selling of domestic 'currency' in the forex market triggered by misinformation spread by speculators with the aim of profiting from the process.

In that sense, it becomes a negative form of investing based on greed.



SPECULATIVE ATTACKS

How are Speculative Attacks set in motion?

- **To give an example, if investors think that the present exchange rate (say Rs. 40 for \$1) is overvalued, they might expect a devaluation (to, say, Rs. 42 for \$1) in the near future. This is what is called a negative expectation.**
- **Some greedy speculators spread misinformation about a possible devaluation in the near future in keeping with the negative expectations and spread panic in the market.**



SPECULATIVE ATTACKS

So...

So, before the attack these speculators buy and hold foreign currency and when the devaluation in the domestic currency takes place, they exchange their foreign currency for a higher sum and thereby profit from it.



SPECULATIVE ATTACKS

Now...

- This triggers panic in the market causing a lot of other investors to also convert their domestic currencies to foreign currencies en masse to escape this loss of Rs. 2 (Rs. 42 – Rs. 40)
- If the speculators had purchased foreign currency (at Rs. 40 for \$1) before devaluation, then they would now earn a profit on it (by selling it to people at, say, Rs. 41 for \$1 which would still be lower than the expected Rs. 42)



SPECULATIVE ATTACKS

Thus, this possibility of earning a profit by artificially creating a fear of suffering a loss is what sets the wheels of speculative attack in motion.



SPECULATIVE ATTACKS

How does one fight it?

- **Plan A: The central bank (the RBI) acting as a guardian of the exchange rate creates a 'fixed exchange rate' system.**
- **To give an example, it starts selling foreign currency at a fixed rate of say Rs. 40 to undercut the greedy investors (who are selling it at Rs. 41) by using the money lying in its reserves.**



SPECULATIVE ATTACKS

Now...

- If the attack has been engineered by misguided investors, then timely intervention by the central bank may help stem the problem.
- But if the problem leads to a fundamental economic weakness, like depleting the reserves of the central bank, then Plan A may not suffice and the government would have to look at an alternate measure.



SPECULATIVE ATTACKS

So Plan B...

- **The central bank may simultaneously raise ‘domestic interest rates’, which makes investment in domestic currency more lucrative.**
- **High interest rates also make it difficult to obtain domestic currency on credit for speculating in the forex market.**
- **This may help in controlling speculative attacks but may hurt the domestic economy.**



SPECULATIVE ATTACKS



But what if

Plan B does not work????

SPECULATIVE ATTACKS

So Plan C...

- **‘Capital Fasting’ in the forex market may also be used in the form of capital controls. The central bank may severely restrict the limit up to which residents can purchase foreign currency.**
- **But, use of capital controls during a crisis can seriously affect capital inflows in the future.**
- **After all, nobody would like to go to a theatre that shuts all the doors during a fire to prevent a stampede.**



SPECULATIVE ATTACKS

Ultimately...

- **The central bank also has to take note of all costs incurred to implement either Plan A, B or C and their respective benefits.**
- **If the costs outweigh benefits, and if there is a genuine demand for foreign currency, then the central bank may even let the currency devalue.**



SPECULATIVE ATTACKS



Hope you have now understood
the concept of Speculative Attacks



Thinking of Investment

Contact

vEcoSys



DISCLAIMER

The views expressed in this lesson are for information purposes only and do not construe to be any investment, legal or taxation advice. The lesson is a conceptual representation and may not include several nuances that are associated and vital. The purpose of this lesson is to clarify the basics of the concept so that readers at large can relate and thereby take more interest in the product / concept. In a nutshell, Professor Simply Simple lessons should be seen from the perspective of it being a primer on financial concepts. The contents are topical in nature and held true at the time of creation of the lesson. This is not indicative of future market trends, nor is vEcoSys IMF Pvt. Ltd. attempting to predict the same. Reprinting any part of this material will be at your own risk. vEcoSys IMF Pvt. Ltd. will not be liable for the consequences of such action.

**Mutual Fund investments are subject to market risks,
read all scheme related documents carefully.**

