Comments on "Does it Pay to Defend – the Dynamics of Financial Crises" by Bauer and Herz

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A Newish Take on an Unfashionable Question

- What is the role of central bank policy in handling exchange rate crises?

Much work on this issue in the 1990s

- Of fading interest, given paucity of exchange rate crises
  - In turn, driven by paucity of exchange rate fixes
  - Result of global switch to inflation targeting

Analysis both Theoretical and Empirical

- Indeed, two parts not closely tied together
- Theory models central bank that can:
    1. Surrender quickly
    2. Defend and win (Hong Kong)
    3. Defend and lose (Italy/Korea/Argentina …)
- Empirics show that aggregating all three types of crises is not warranted
    - Unsuccessful defenses associated with worse economic outcomes

Theoretical issues

1. Are speculative attacks expected or unexpected?
   - Flood-Garber theorem: any regime switch (result of policy) *observationally equivalent* to unobserved switch in fundamental process (hard to measure!)
2. Are speculative attacks driven by fundamentals or is there non-trivial multiplicity of equilibria?
   - Is the unsuccessful defense itself the cause of the poor outcome? Or was latter inevitable? (Dooley)

3. Why was fixed exchange rate regime initially optimal (before attack)?

- What changes with the attack that switches the optimal regime?

4. What's the future monetary regime (after successful attack)?

- Absent here, though agents ow maximizing
- Can this issue be ignored? Tradition from Krugman/Flood-Garber is to specify post-attack monetary policy to induce speculative activity

Empirical Issues

- This literature is notoriously sensitive
  - Easy to cheat by choosing outlier thresholds, windows, exact components of crisis, controls, …
- What’s the theory behind using both reserves and interest rates (assets imperfectly-substitutable?)
- How do empirics tightly link to theory?

Other Suggestions

- Good figures and tables should be self-contained, self-explanatory, and B&W