"Defending Against Speculative Attacks":
Some comments

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Bottom line

➢ Paper hits trifecta

    ➢ Straightforward econometrics

    ➢ Clear policy message

    ➢ Makes you stop and think

Policy message

1. Successful speculative attacks are costly

2. So, central banks should defend the currency

3. But this requires consistent macro policies

4. If not possible, better not to try

Approach

➤ Causal chain of events

   1. Pre-crisis conditions
   2. Crisis ("speculative attack")
   3. Central bank response
   4. Post-crisis conditions

➤ Findings

   ▪ Pre-crisis conditions are similar
   ▪ Post-crisis conditions are not
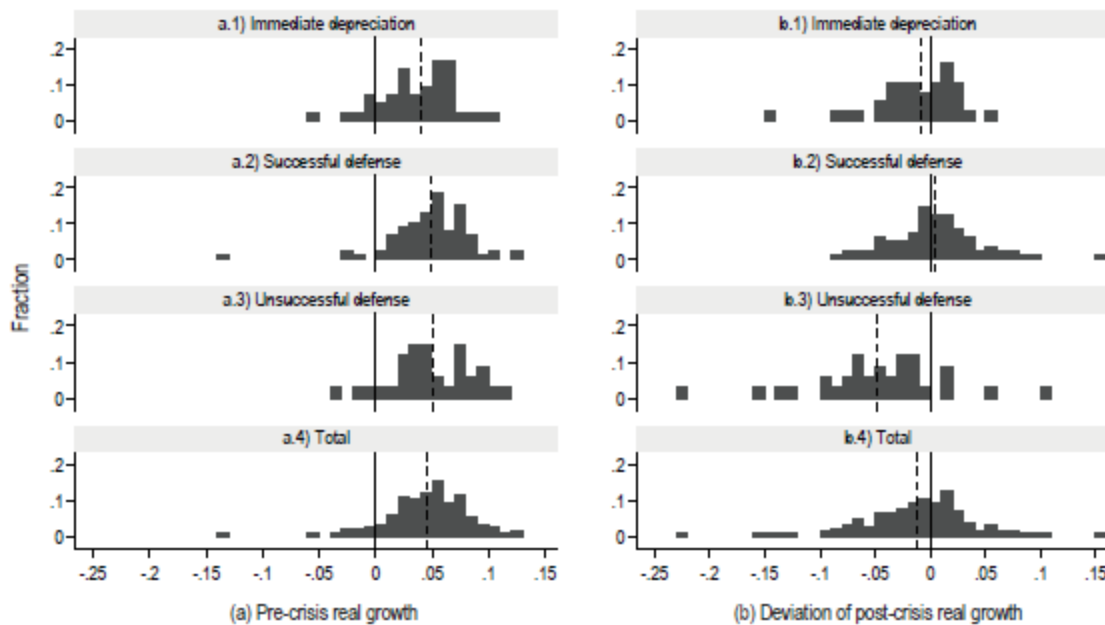   ▪ So, stage 3 is critical

Evidence

Figure 3: Currency crises and real growth (dashed lines indicate the respective crisis mean).
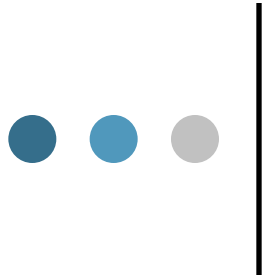
Timely Reminder!

➤ Rupee suffered speculative attack in July-August

➤ RBI response:

  ▪ Raised MSF rate to 10.25 percent in mid-July
  ▪ But kept repo rate low, told banks not to raise lending rates

➤ Policy was inconsistent, and failed

➤ ER stabilized only after problems addressed:

  ▪ Made Indian assets attractive (swap scheme on Sept 4)
  ▪ Reduced CA

India's Speculative Attack
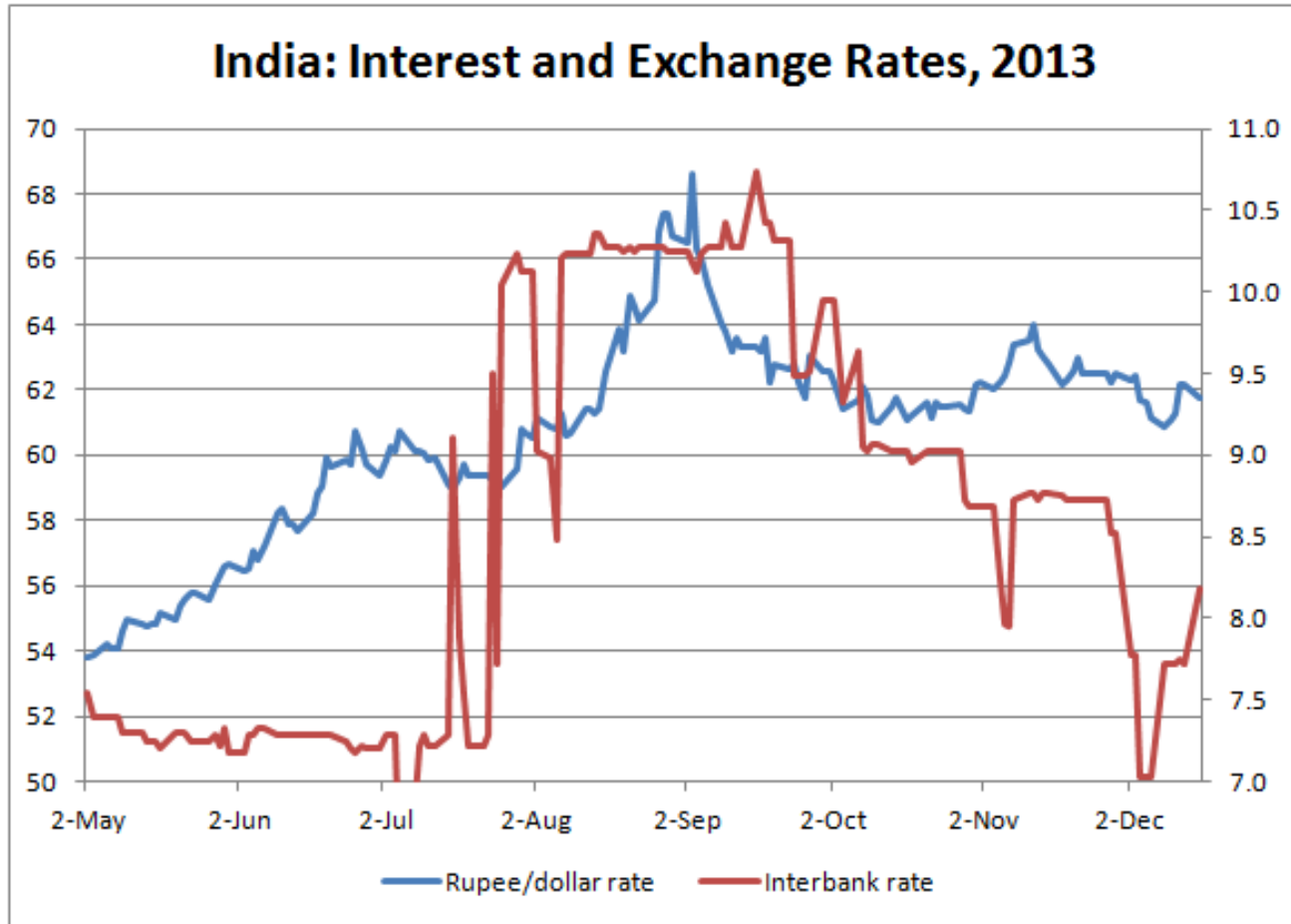
➤ So, are we done?

➤ Not at all!

Nagging question

➤ Is currency defense really the best policy?

Go back to causal chain

1. Pre-crisis conditions
2. Crisis ("speculative attack")
3. Central bank response
4. Post-crisis conditions

Initial conditions

➤ Model cannot predict crises

- Crises are random?
- Model misspecified?

➤ In first case, initial conditions don't matter

- Paper's conclusion holds

➤ But what if second case is true?

- Haven't controlled properly for initial conditions
- Cannot be sure whether outcomes are result of treatment
- Problem!

Indonesia's crisis

Indonesia: Exchange Rate and Growth, 1997-98
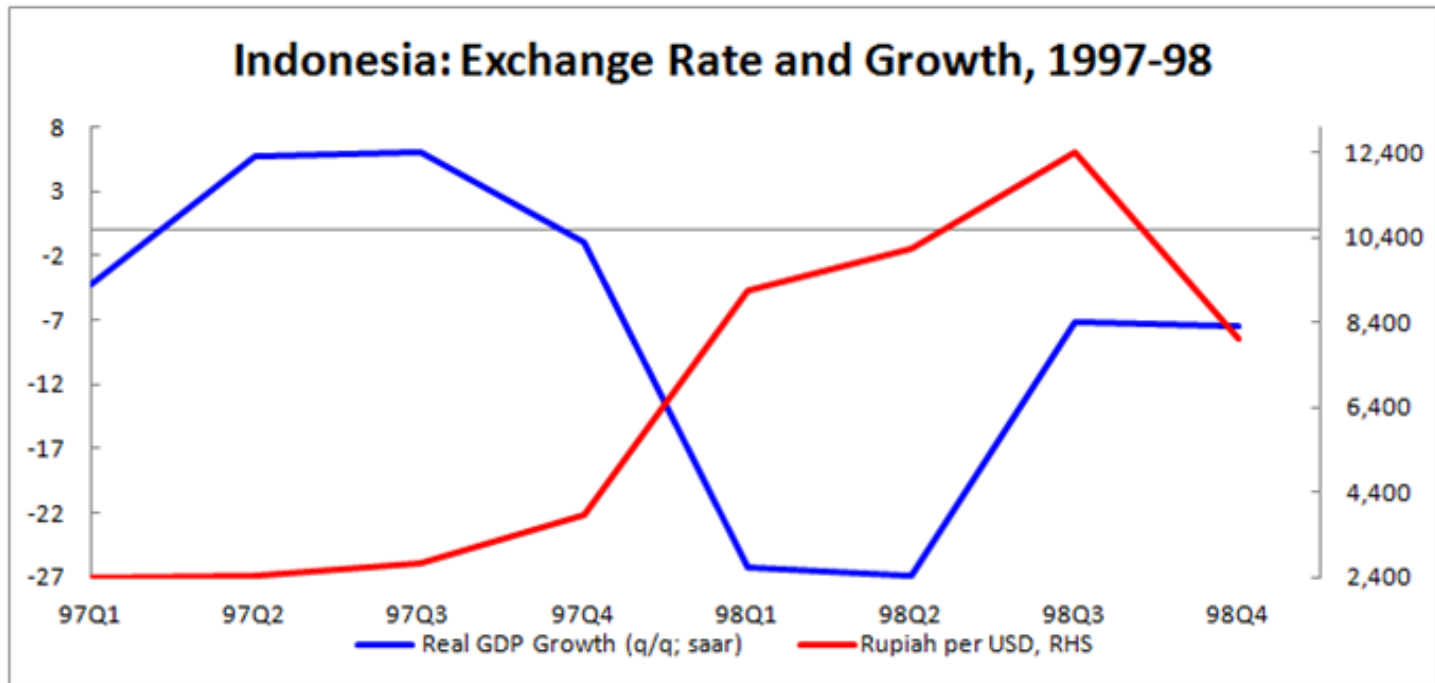
Why so severe?

- Initial conditions!

- Severe vulnerabilites:
  - Very high corporate leverage
  - Much in fx

- Not in model

- Implications?
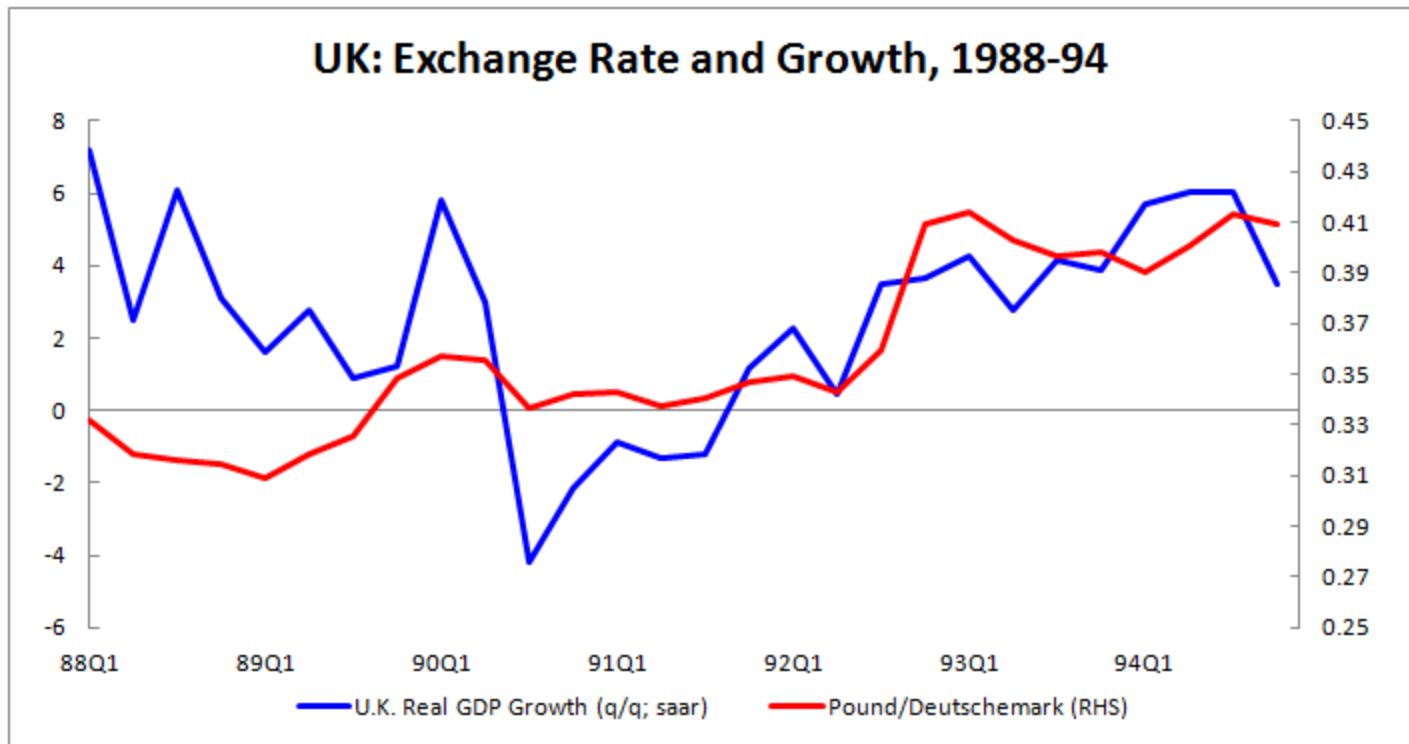
Why do cb's defend currencies?

➤ Often *precisely* because there are large vulnerabilities

   ▪ Same reason why speculators attack
   ▪ Defense in these cases tends to fail
   ▪ Aftermath proves costly

➤ Consequences of overlooking vulnerabilities (Step 1)?

   ▪ Overstate importance of central bank strategy (Step 3)
   ▪ Overstate cost of failed defense, per se (Step 4)

➤ Implication: currency defense may not be best policy!

Second example

- Consider opposite case: no vulnerabilities

- But recession, with er pegged to booming country

- Implications

  - Interest rates will be too high
  - Encourages speculative attack

- Central bank options (step 3)

  - Currency defense will be very costly

  - Abandoning peg could help economy

UK: ERM Crisis

UK: Exchange Rate and Growth, 1988-94

— U.K. Real GDP Growth (q/q; saar)   — Pound/Deutschemark (RHS)

Conclusion

➤ Controlling properly for initial conditions could overturn results

➤ In countries without vulnerabilities such as fx debts:

  ▪ Speculative attacks may *not* be costly
  ▪ Currency *defenses* can be costly

➤ Policy implication: er float is best strategy!

THANK YOU