Discussion of ‘Identifying the early warnings of currency crises in India’ by Balaga and Padhi

Ajay Shah
http://www.mayin.org/ajayshah

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1. What is a crisis?

- A crisis within the regime vs. a breakdown of the regime.
- E.g. if there is a large movement in the exchange rate, in a floating exchange rate, that’s not a crisis.
- India has been through major changes in the exchange rate regime.

We should ask:

1. Why did the exchange rate regime change?
2. Within a given exchange rate regime, what explains the outlier months?
The Indian saga of the exchange rate regime

[Graph showing annualised volatility with key data points:
- 23 May '03: 1.84
- 23 Mar '07: 3.87
- 4.74 years
- 3.84 years
- 10.72 years]
2. Exchange market pressure

- There are problems with measurement of traditional EMP methods.
- E.g. in your version, $\Delta R$ is in the denominator, so in the floating period, you will get very large EMP values.
There is an $I - S$, which is being financed by foreign capital inflow.
The risk perception changes. The foreign capital chokes.
In the short term, the exchange rate adjusts.
By how much? By enough to excite short term debt flows.
In the short run, the only thing that stabilises a free falling currency is short term debt.
So what factors might matter?

Sudden changes in risk perception

1. Asymmetric information: Gaps between perception and reality.
2. Trust in local institutions, predictability.
4. Exchange rate management that gives currency mismatch (either corporate or government).

Responding to a situation

1. Openness to short term debt
2. Deep and liquid currency spot and derivatives market
3. Maturity of government response: sound fiscal, financial and monetary institutions.

Numerous articles on the 2013 crisis on my blog.

Ajay Shah http://www.mayin.org/ajayshah
Thank you.
http://ajayshahblog.blogspot.com