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
  o In turn, driven by paucity of exchange rate fixes
  o 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