Volume Title: Currency Crises

Volume Author/Editor: Paul Krugman, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-45462-2

Volume URL: http://www.nber.org/books/krug00-1

Conference Date:

Publication Date: January 2000

Chapter Title: Comment on "Current Account Reversals and Currency Crises: Empirical Regularities"

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Chapter URL: http://www.nber.org/chapters/c13092

Chapter pages in book: (p. 323 - 325)

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Comment Jaume Ventura

This is the latest paper in a series by Milesi-Ferretti and Razin (1996a, 1996b, 1998) that has taught us much regarding current account sustainability and sharp reductions in current accounts. In this new installment of the saga, the authors also include a description of large depreciation episodes. In this brief comment, I focus on two issues. First, I raise a methodological point that I hope the authors interpret as a challenge for their future research. Second, I stress some of the implications of their findings regarding large depreciations.

Section 8.4, on current account reversals, contains a description of how the key macroeconomic variables (with special attention to growth) behave during a current account reversal.[1] In particular, they find that on average these episodes tend to be preceded by unfavorable terms of trade, low foreign exchange reserves, a high interest burden of external debt, low consumption growth, and a high budget deficit. After the sharp reduction in the current account deficit takes place, on average most of these indicators improve, although the growth rate remains at roughly the same level

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1. Section 8.4 also contains an attempt to use multivariate probit analysis to find good indicators of current account reversals. However, this effort is marred by the use of the current account variable as a regressor. This variable was used to construct the dependent variable, and as a result, it cannot be used as an explanatory variable. I suspect that the numbers might change substantially if the probit analysis were properly executed.

as before the reversal. These results regarding average behavior are beautifully summarized in figures 8.1 and 8.2.

But how do we interpret these findings? In other words, what is the question being answered by these figures? Before tackling this issue, it is worth remembering that economic theory offers a variety of reasons for why these reversals take place. Consider the following three possibilities:

1. A country receives a bad shock to productivity or the terms of trade, which is expected to last for an extended period of time. As a result, domestic investment falls and capital moves out of the country. The current account goes into surplus. In this story, the reversal is accompanied by a fall in output and a real depreciation.
2. A country receives a good transitory income shock. Spending increases by less than output, as agents try to smooth consumption over time. The current account goes into surplus. In this story, the reversal is accompanied by an increase in output and a real appreciation.
3. Foreign interest rates increase, international investors lose confidence in a country, or alternatively, the credit constraint of a country is tightened. Capital moves out of the country, spending falls, and the current account goes into surplus. In this story, there might be a fall in output if foreign financing is necessary to keep alive some investment projects with high future return. Also, the exchange rate might depreciate.

Stories 1 and 3 suggest that a current account reversal should be accompanied by a depreciation of the currency and a reduction in output. Story 2 suggests instead that a current account reversal should be accompanied by an appreciation of the currency and an increase in output. It should be obvious to the reader that other stories are possible with different implications. The only point I want to make here is that there are, in principle, many varieties of current account reversals, each of them caused by a different type of shock. With this in mind, consider the following two questions:

Q1. Assume we know that a reversal will take place but we do not know why: what should we expect the macroeconomic picture to look like?

Q2. Assume we know that a reversal will take place because of reason X: what should we expect the macroeconomic picture to look like?

Figures 8.1 and 8.2 are the response to Q1. The sample paths depicted in these figures could be roughly interpreted as weighted averages of the sample paths of each type of current account reversal, with weights that correspond to the frequency with which each type occurs in the data. For instance, the authors find that there is little effect on growth after a reversal. Is this because reversals have little impact on growth? Or is it because about half of the reversals in the sample are of type 1 or 3, while the other half are of type 2? The answer is not clear.

A much more interesting question is Q2. To answer it, we would have to establish a typology of current account reversals and then separate the observed episodes according to this typology. While the information provided in this paper is useful, I think the authors should try to address Q2. This effort would be more useful to the academic economist who wants to use the results of this paper to learn about parameters of the economy. It would also be more useful to the policymaker who has information regarding the shock that the country is experiencing.[2]

The second point I want to raise concerns the interpretation of the evidence on currency crises. The methodology used to determine episodes of "currency crisis" consists of picking periods in which there are large depreciations. Once we look at the data this way, the evidence in figures 8.3 and 8.4 can be interpreted as showing that countries follow textbook policy prescriptions (unless they receive a sizable amount of concessional debt). In particular, countries devalue whenever the terms of trade worsen, there is low growth and high interest rates in the OECD, reserves are low, and the currency is overvalued! In such circumstances, there is a temporary output loss, which is consistent with old-fashioned J-curve arguments.

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2. Clearly, the same set of issues arises in section 8.6, on currency crises.