Discussion of

# Learning Dynamics and Endogenous Currency Crises

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*Objective of the paper*

What triggers currency crises?

*Outline of the discussion*

- Positioning of the paper in the literature

- Summary and intuition

- What I like

- What I like less

*Where does this paper stand?*

Early currency crises models (Krugman, 1979)

Explain why crisis happen and why they are sudden events BUT

*crises are triggered by fundamentals*

Recent evidence (Kaminsky, 1999) Some crises are hard to predict using fundamentals. Prime examples are the Asian Crises (Malaysia)

Large body of literature trying to generate crisis with small or no changes in fundamentals

- Multiple equilibria (Cole and Kehoe, 1995 Aghion et al. 2001)

Economies with incomplete markets and sunspots, BUT *why and when* we switch from the good to the bad equilibrium?

- Informational frictions

-Herds (Chari and Kehoe, 2000),

-Global games (Morris and Shin, 1998)

When fundamentals are bad country enters a crisis zone.

In this crisis zone information diffusion uniquely determines whether the crisis happens or not.

*CK is related in the sense that the equilibrium is unique and "crisis-like" are of informational nature*

How is it different?

Open economy expectationally augmented Phillips curve

Exchange rate appreciation are expansionary (Balance sheet effects)

In the Nash equilibrium there is an appreciation bias.

The Ramsey equilibrium has a depreciated exchange rate

Informational friction

-The model used by the PM is mispecified

-PM estimates the parameters of the mispecified model using fixed gain.

As in Sargent (1999) the equilibrium stochastic process for exchange rates display a mean Nash behavior and recurrent "escapes" from Nash to Ramsey. In a escape phase there is a sudden depreciation and (balance sheet effects) an output drop.

*It looks like a currency crisis (Asian Style).*

What determines the mean and escape dynamics?

The PM believes can affect output by appreciating the exchange rate. As it starts doing it (Mean Dynamics) its effectiveness will decrease since the private sector revises its expectation. Certain shock realization plus the fixed gain algorithm can lead the PM to believe that the exchange rate has no effect on output. In that case it will set to exchange rate to the (depreciated) Ramsey level. This is the Escape Dynamics.

*What I like about the paper*

Frequency of escapes is endogenous and is function of the deep parameters of the model.

We can study their likelihood as function of the preference or learning ability of the policy makers, or of the structure of the economy.

*What I like less about the paper*

Are escapes really good models of currency crises?

Escapes are episodes in which the PM realizes exchange rates have no effect on output so it sets it to the Ramsey value. This makes a lot of sense for inflation policy but do we believe that the large depreciation in the Asian crises were a deliberate policy choice as the Volcker one?

Escapes are episodes associated with the government "doing the right thing", not true of crises.

Also consider the case of the ERM. There absence of foreign denominated debt would suggest $\theta > 0$ (devaluation are expansionary). In this case escapes would not be currency crises but currency sudden appreciation. So escapes would not be a good model for those crises