Exchange Rates Matter Less Than We Think (Part 3)

By Antonio Fatas

For countries that have been running a large current account deficit for years, a “sudden stop” of capital is contractionary, regardless of the flexibility of exchange rates.

I did not realize that some of my earlier posts on sudden stops and the Euro area would be so controversial. I thought I was making a simple point. And this time, those who disagree with me are the ones that I always agree with so it makes me think even harder about whether the argument that I was making is right!

Brad DeLong wrote a **post** to show that sudden (capital) stops should not be a concern for countries that have their own currencies. Let me start with all the arguments where I do not have any disagreement:

- Talking about the possibility of a sudden stop in the UK or the US makes no sense. I agree. The comparison that some establish to argue that the "US is the next Greece" is idiotic.
- Countries with fixed exchange rates that have accumulated a large amount of debt denominated in foreign currency are more likely to be exposed to crisis caused by sudden stops. Correct.

Where we disagree is on whether sudden stops are relevant to other countries with flexible exchange rates. My argument is that in cases where countries have been running a large current account deficit for years, a sudden stop of capital could be contractionary (i.e. cause a crisis). Brad DeLong is more optimistic and argues (using the IS-LM model) that, on the contrary, a sudden stop will be expansionary because the exchange rate depreciation will boost exports. The argument is correct within the context of that model but I think that the model is missing several ingredients. There is no one real interest rate in financial markets. You might fix this by adding

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some risk premium to the model (e.g. the interest rate in the investment equation has an extra term). As long as that extra term is constant it will look as if you can still generate an expansion by controlling the real interest rate but I think that in some cases, markets just fail to even provide a proper price for certain assets/risk and we are in a world with multiple equilibria (or simple some markets disappearing) and this changes the predictions of this very simple linear model. That is the point that Blanchard and Leigh do that Brad DeLong also disagrees with. I used to think that these scenarios were impossible in advanced economies but my view on financial markets and the possibility of multiple equilibria changed substantially during the 2008-2013 crisis.

But is the real disagreement about financial markets or about the role of exchange rates as an adjustment mechanism during times of crisis? Let me argue that they are related. There is a divide between US and European economists when it comes to this debate. Even among those who come from similar ideological backgrounds and support similar models, I have found that US economists tend to put a larger weight on the benefits of flexible exchange rates. Europeans tend to be more skeptical. It might be because there is a bias (Europeans are "proud" of the Euro). But I think that there is also a belief that financial markets (and foreign exchange markets) are more imperfect than what the traditional model of flexible exchange rates suggest. Bubbles, mispricing of currencies, financial imperfections, animal spirits, multiple equibria all move you away from the theoretical benefits of flexible exchange rates.

Who is right? I have no disagreement with the logical arguments that Brad DeLong makes, but what would really make me change my mind is empirical evidence about the behaviour of interest rates or exports or exchange rates during the crisis that supports those models (e.g. why did the depreciation of the British pound not have a larger effect on exports?). My latest post had been motivated by the results of Rose on the irrelevance of exchange rate regimes during the crisis. The results are interesting and suggest that exchange rates matter less than we think. They are not definitive, there are always hypotheses that cannot be tested with the data we have but to me that's the only place to make progress in this debate, we need more and better empirical analysis.

[Update: ***Paul Krugman*** *does not like my arguments either and he asks for*

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a model. Fair point and I do not have one but I see my arguments as being consistent with models that others have written. I am looking for one when I find more time. But my argument is mostly empirical: I cannot think of many countries where a sudden stop has led to an expansion. To be continued.]

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