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"Self-Oriented Monetary Policy, Global Financial Markets and Excess Volatility of International Capital Flows"

(R. Banerjee, M. Devereux & G. Lombardi)

A discussion by Aitor Erce (European Stability Mechanism)

Very timely and relevant issue

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[Capital flows volatility] After a sustained period of very accommodative MP worldwide, concerns regarding spill overs from US MP on EMEs are at the forefront

- The Fed tapering talk triggered market turmoil during 2013…
- Do US MP policy create an "externality" in other economies?

[Policy] Given the increased volatility associated with the US MP stance, a debate is ongoing regarding whether, with free capital mobility, flexible exchange rates are sufficient to protect countries from (forthcoming?) external (US) monetary/financial shocks.

- Global cycle ties capital flows dynamics to US MP stance?
- Trilemma versus Dilemma?

The paper in a nutshell – Set-up

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Two-region (core & periphery) DSGE.

Core and a periphery engage in production, trade and financial transactions:

- Peripheral residents purchase foreign T-Bill
- Core residents deposit in core (global) banks
- Core banks finance periphery banks who, in turn, finance domestic activity.

Banks face financial frictions: double agency problem.

Analyse policy options with and without frictions:

- Debt issuance in core or peripheral currency
- Peripheral exchange rate free-floats or is pegged
- CBs follow Taylor-rule or optimal non-cooperative

The paper in a nutshell – Findings

Findings:

- Effect of monetary shocks depend on policies and frictions
  - Periphery (P) reacts more than Core (C) (accelerator^2)
  - In the absence of frictions, flexible exchange rates work
  - Real effects of shocks stronger if P's CB defends a peg
  - The effect of frictions is ameliorated if P borrows in own currency.
- Non-cooperative optimal MP can protect P

Policy message:

- Financial frictions bring the trilemma for P closer to a dilemma, but MP is not powerless.

The missing “elephant in the room”?

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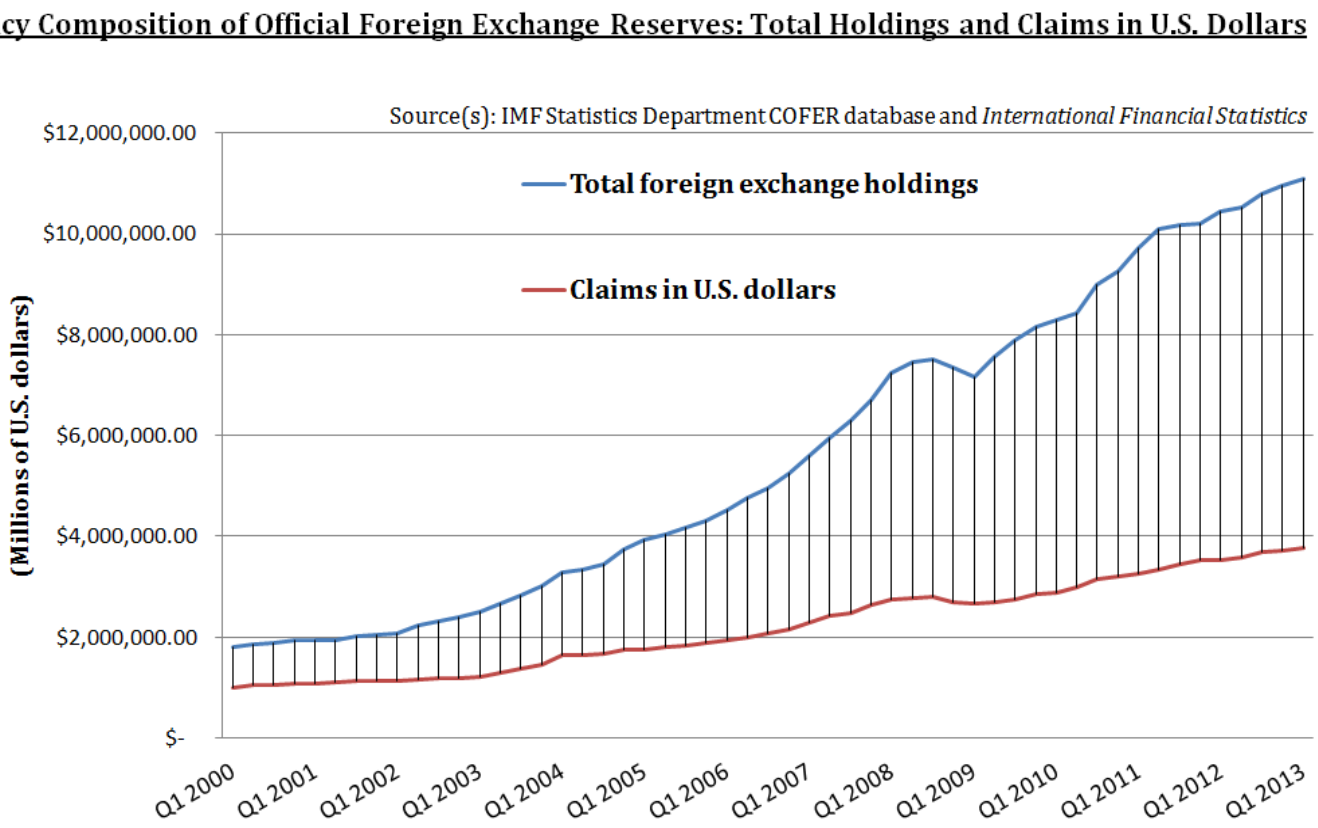
As described (f.i.) in Alberola et al. (forthcoming), EMEs’ main war-chest against sudden stops is

INTERNATIONAL RESERVE ACCUMULATION



On exchange rate policy

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[What] The paper presents a set of results for the case in which the CB defends a peg

[Doubt] Unclear how this is implemented

[Needed] More detailed balance sheet of the Central Bank is needed

[What] In reality, CBs use international reserves to help them manage their exchange rates

[Needed] Should not you explicitly model reserve accumulation?

On Gross Flows and the NFA

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[What] The model delivers gross capital flows retrenchment in line with Broner et al. (2013)

[What] What drives the international investment position behave in this model?

[What] If shock to C, P-residents deposit less abroad and C-banks deliver less credit to P-corporates

[Doubt] How much of the retrenchment is just due to the modelling choice (P-residents save using C T-Bills)?

[Doubt] What would happen if P-residents could deposit at home?

A bit more on Gross Flows…

[Fact] the first of line of defence against capital flows volatility is reserves

[Fact] According to Alberola et al. (forthcoming), gross flows dynamics during global stress depend on the stock of international reserves (complementarities?)

[Needed] Should not you explicitly model reserve accumulation?

On Core´s public debt

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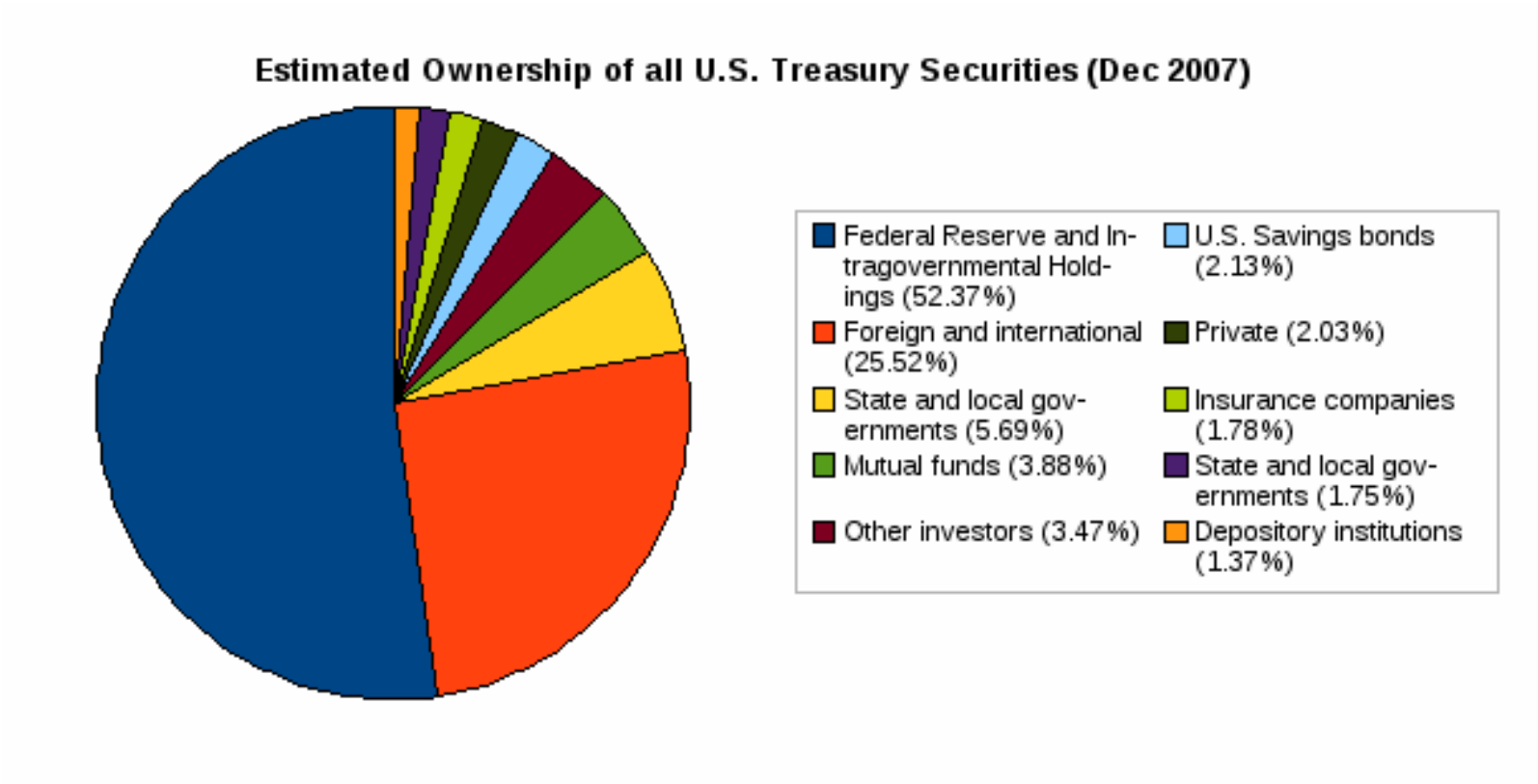
[What] C T-Bills are only purchased by P-residents.

[Doubt] The C T-Bills investor base is 100% P-based? Factual?



On Leverage

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[Doubt] What is the right level of leverage?

- Some EMEs leverage is similar to the US, others have much larger ratios
- In 2009: US=10.2 vs. China=20.5 or India=14.5
- Kalemli-Ozcan et al. (2012)

[Doubt] What are the dynamics of leverage?

- LatAm Banks have a constant K ratios. Powell (2015)

[What] How does the model work if frictions only at C banks and/or only at P banks

On the IRFs

- Without frictions: C MP shock delivers an increase on public debt in C.
  - Is this intuitive/factual?

- With frictions: a variety of outflows dynamics.
  - In some cases capital flight in others domestic retrenchment (see Alberola et al., forthcoming)

To close…

Very nice paper designed to assess policy trade-offs in the presence of a global financial cycle.

Still, some way to go:

I miss some more freedom of choice for investors

If the model is about EMEs, I miss a different characterisation of the CB´s objectives and instruments (is the Taylor Rule a good characterisation?)

Or is this a model of other advanced managing US MP shocks?

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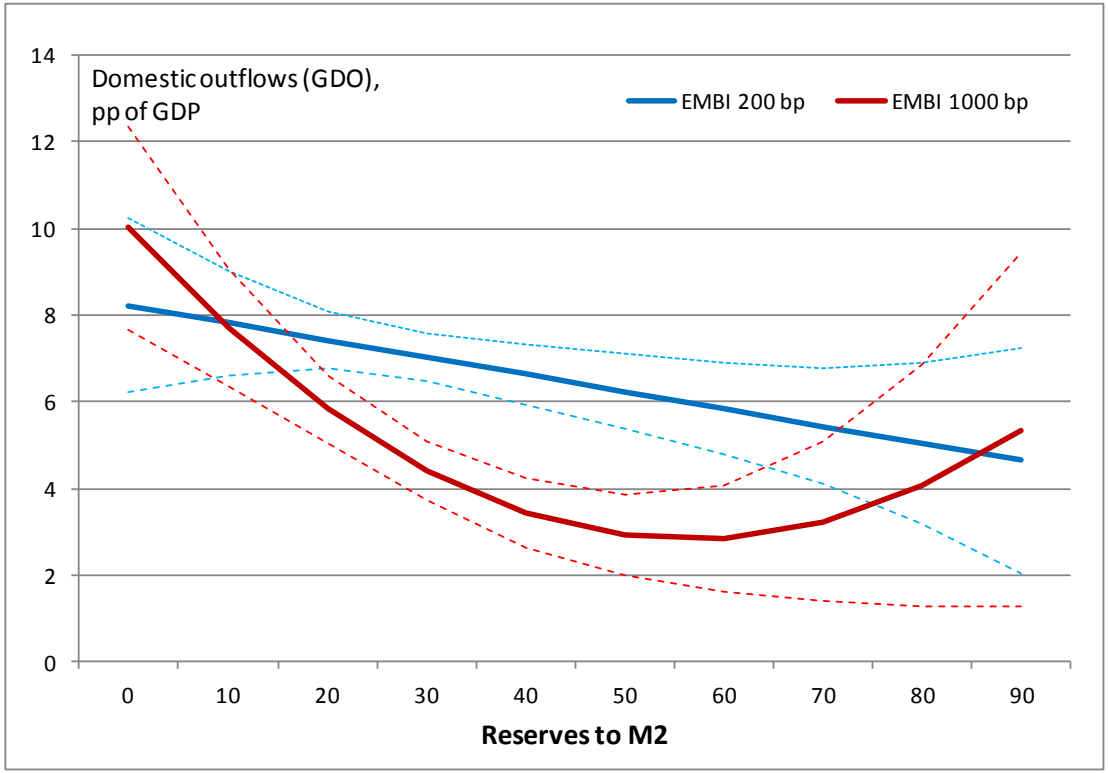
Thank you!!!

Reserves and gross capital flows (Alberola et al., forthcoming)



During global crises, domestic outflows are lower, the larger the country's stock of international reserves

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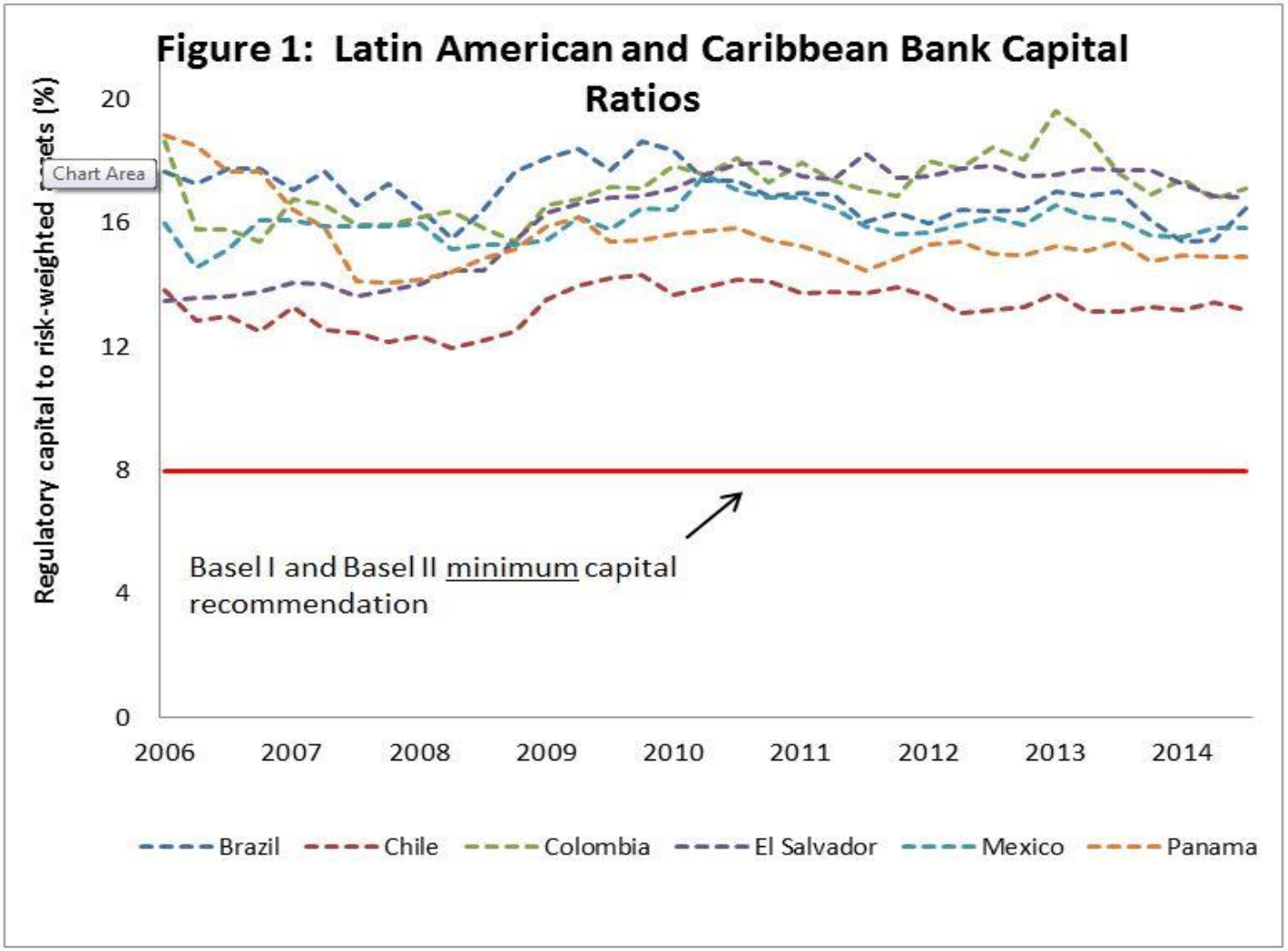
LatAm Bank capital ratios (Powell, 2015)



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