Discussion of Gómez (2009): *Capital flows and monetary policy*

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Question

Do the choice of monetary policy regime and the currency denomination of foreign debt really matter for an (emerging market) economy facing capital outflows?

Answer

YES!

Answer from the North Atlantic

OH YES!

Iceland

- Highly leveraged economy and widespread FX borrowing
- Large credit expansion and asset price boom since early noughties (coinciding with liberalisation and privatisation of banks) led to sky-rocketing private demand
- Substantial appreciation of ISK followed by sharp depreciation through 2008 (global liquidity measures fell, credit default swaps for Iceland rose)
- Banking sector collapsed in autumn 2008
- Sharp fall in asset prices, and increase in debt levels
- Relatively tight monetary policy and IMF programme including capital controls to avoid further weakening of ISK
- Bankruptcies and large contraction in domestic demand
- Positive contribution from net export (large import contraction) limits fall in output

Caveat

- Paper argues that model captures 'sudden stops' as result of exogenous shock to country risk premium
- However, this is not a model of financial crisis
  - Small deviations from well-defined steady state
  - No permanent wealth transfers
  - No banks
  - No bankruptcies
  - No sustainability issues
  - No credibility and confidence issues
- Taylored to explore effects in 'normal times'
- Illustrate many of the mechanisms nevertheless!

Technicalities

- Carefully done!
- But a couple of issues with short-cuts

$$E(XY) \neq E(X)E(Y)$$

$$\alpha_t \equiv \frac{B^*_{F,t}}{P_t N_t} \stackrel{?}{=} \alpha$$

$$(1+\phi_{C,t}) = (N_{t-1})^{-\zeta}\left(1+\varepsilon_t^{\phi_C}\right)$$

Baseline model

- Endogenous country risk premium subject to shock but no financial accelerator
- The central bank has conventional monetary policy instruments as its disposal
- Positive risk premium shock gives central bank the choice between
  - Increasing interest rates along with risk premium to support exchange rate
  - Allowing exchange to depreciate by avoiding increases in interest rate (beyond what is needed to induce determinacy)
- Choice determines outcome to positive risk premium shock
  - Higher interest rates depress aggregate demand and lead to a recession
  - A depreciated exchange rate stimulates net exports and leads to expansion

Baseline model

- A recession caused by the interest rate defence of an exchange rate peg may be the mechanism Chari, Kehoe and McGratten AER 2005 were looking for
- Common argument against IMF prescriptions
- Effect is real but ignores important policy concerns
  - Small illiquid FX market may be overwhelmed by flows
  - Overshooting may complicate balance sheet reconstruction
  - Confidence in currency may be compromised
  - Credibility of monetary policy may need restoration
  - Debt dynamics may become unsustainable
  - Balance sheet effects may come to dominate
- Recognition of monetary policy trade-offs essentially reason why capital controls are part of IMF programme for Iceland

Baseline model

- Consider the effect of changing the currency composition of debt in baseline model with floating exchange rates
  - Small feedback effect of debt dynamics - and therefore of currency composition - on risk premium and real economy as ζ is small
  - But higher α works to increase debt on impact of a positive premium shock due to valuation effect of depreciation
  - This leads to a higher country risk premium through the endogenous component
  - ...and further depreciation and a larger net export boom (allowing debt to recover quickly)
- Normal times: More foreign currency denominated debt likely to increase fluctuations slightly with floating rates
- Welfare analysis and comparison of regimes with Ramsay plan would be nice extention

Extended model

- Balance sheet effect on aggregate demand is added to baseline model: Aggregate demand decreasing in debt
- If economy is highly indebted (strong valuation effect) and not too open (net export effect not too strong), the balance sheet effect may result in recession also under float
- But what is the effect of the currency composition?
  - Higher α likely to deepen recession
- Again, welfare analysis and comparison to Ramsey plan would be helpful
- Normal times: Seems that peg may be preferable in open resilient economies and float in less open and vulnerable ones.

Extended model

- Compared to Gertler, Gilchrist and Natalucci JMCB 2007...
  - Observe that 'defending an exchange rate peg generally requires the central bank to adjust interest rates in a direction that reinforces the crisis'
  - Financial accelerator contractionary (abandoned peg)
  - A higher share of foreign currency denominated debt enhances financial accelerator effect (float less attractive but still dominant)
- ...what exactly is the contribution in this paper?
  - Analysis of effects from currency composition on output?
  - Debt dynamics?
  - More thorough analysis of combinations (regime, indebtedness, openness, currency composition)?
  - Normal times or crisis?
  - Response to Chari, Kehoe and McGratten AER 2005?

Extended model

- Parsimonious balance sheet feedback mechanism has appeal but boom-bust cycles suggest that there is more to the story
- Financial accelerator: Effects stemming from borrower balance sheets
- Icelandic experience: Sharp contraction also in the supply of credit (following a long period of unsustainable credit expansion)
- Banking likely to be vital for balance sheet effects (beyond the value of μ) as well as endogenous dynamics of risk premium
- Maybe news shocks, updating or learning/misperception mechanisms
- Shocks elsewhere, e.g. in banking sector, that generate endogenous movements in country risk (perceptions)?