

Discussion on "Hot Money and Serial Financial Crises"

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Summary

- Paper addresses the issue of crisis propagation across countries (i.e., serial financial crises).
- What's the mechanism?
 - (i) If a credit constrained country is hit by a negative output shock, financial amplification channel decreases borrowing,
 - (ii) In response, credit (i.e., hot money) is reallocated to other countries,
 - (iii) Higher indebtedness makes other countries more vulnerability to future output shocks.
- Very relevant for the current policy debate (e.g., US and Brazil).
- Policy implication: "macro prudential policy" in the form of limiting the amount that countries borrow.

How is this analysis conducted?

- Multi-country extension of related models that have been used for small open economy emerging market crisis (see Benigno et al. (2009), Bianchi (2009), Korinek (2008) Jeanne and Korinek (2010))
- Three agents/countries: international investor and two countries that borrow from international investor.
- International endogenous borrowing constraint (financial amplification channel) for both countries: endogeneity depends on the value of current asset prices (existence of pecuniary externality that creates a scope for policy)
- Policy prescription comes from comparing competitive equilibrium allocation with social planner allocation

What is new/interesting?

- Interest rate determination: supply of credit from international investors is an increasing function of the interest rate. When demand of credit is lower, equilibrium interest rate declines. Transmission of crisis occurs not only through reallocation of credit, but also interest rates.
- Extension to multi-country model opens the debate on issue of contagion and policy coordination.
- Promising work that advocates macro prudential policy.

- 1 Proposed mechanism for serial financial crises
- 2 Inefficiencies and policy response
- 3 What are the general equilibrium implications? (i.e. interaction among countries)

- Crisis in country A does not endogenously lead to a crisis in country B. But if there is a subsequent exogenous negative output shock in B, ensuing crisis will be more severe (subject to a binding borrowing constraint). Otherwise, B benefits from lower interest rates. Also, subsequent crisis in B speeds up recovery in A.
- What are the welfare costs of the serial financial crisis channel (in addition to the exogenous output shock)? Quantitative example suggests they might be small.
- What is the relevant empirical evidence for the presence of serial financial crisis channel?
- Current crisis (see Krugman, 2008) has pointed out mechanism through asset price contagion (~international financial multiplier). It would be interesting to check asset price comovements in this model.

- Logic of this models: you cannot borrow as much as you would like when you need the most. First best allocation is the economy in which there are no borrowing constraint. Need to think about policies that address the existence of the constraint.
- Social planner vs. competitive equilibrium: in this economy there are divergences between the two allocations when the constraint is binding and when it is not. In particular, when the constraint is binding social planner has an incentive to affect asset prices by manipulating the discount factor. What happens in the binding region? What should we do when the crisis occurs?
- Related work (see Benigno et al. (2009) for small open economy with production) shows that crisis management policies might be more relevant than macro-prudential ones.

- Potentially interesting general equilibrium implications from interaction among countries.
- Model in the normative part is silent about strategic interaction between countries.
- Macro-prudential recommendation is based on small open economy analysis but interest rate is determined by the interaction of all countries choices so that strategic elements play a role in the normative part through the interest rate.