Discussion of

"Macro-Financial Implications of Surging Global Demand (and Supply) of International Reserves

by

Enrique Mendoza and Vincenzo Quadrini

Charles Engel
University of Wisconsin – Madison

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Aim of the Paper

- The paper considers the effects of reserve accumulation by emerging markets and debt issuance by major country governments on financial stability in emerging markets.
- Also, as emerging markets have become an increasing part of the world economy, how is stability affected in the advanced countries?
- The interesting twist in this paper is to consider defaultable debt of private agents (firms) owed to other private agents.
  - That is, financial stability here is not concerned with the sustainability of public debt, but rather of privately issued and privately held debt.

Very nice paper!

- It is not a simple task to handle a global general equilibrium model (2-country) with heterogeneous agents (borrowers and lenders) within each country.
- The paper makes several clever assumptions that make the model manageable.
- I expect the model will serve as a template for further work on financial stability in global markets.
- There may be a tradeoff between tractability and the credibility of the quantitative findings.
  - Like a typical referee, I will make some suggestions without considering how difficult it might be to implement my suggestions.

Main Findings of the Paper

- An increase in government debt issuance (by the US) reduces global volatility
  - By increasing interest rates, private borrowing is discouraged.
  - With less private debt, the possibility of default is diminished.
  - Fewer defaults imply lower volatility.
- When emerging markets acquire reserves, it reduces the amount of public debt in circulation.
  - Their demand for US debt reduces interest rates.
  - This encourages private borrowing, higher debt levels
  - Defaults are more frequent and volatility is higher.

Main Results (continued)

- If the emerging markets use the reserves to bail out lenders who have suffered from default on loans they have made, then in fact volatility may be reduced.
- Welfare effects of debt issuance and of reserve accumulation tend to be ambiguous.
  - Households may gain when entrepreneurs lose, and vice-versa.
  - Some of the important welfare effects come not from the effects of volatility, but from "level" effects of interest rates.
- The main point of the paper is that private borrowers and lenders don't "cancel" each other out – there are macro effects of defaults on private loans to private entities.

Comments

- The quantitative effects of reserve accumulation and debt issuance depend on the specifics of the model.
  - I have some questions and suggestions about the specifics.
- What exactly is the collateral constraint facing entrepreneurs/lenders?
  - The paper says that they face a working capital constraint, but then also says it might provide insurance against earnings risk; or, that firms with assets may more easily attract workers or retain existing workers.
- Is there really direct firm-to-firm lending, or do lenders use financial intermediaries?

Financial Constraint

It's striking to me that the constraint in this model is firms must hold a minimum amount of assets, *m*:

m >= working capital needs

But in a Gertler-Karadi-Kiyotaki model, financial intermediaries must not have too many assets – a leverage constraint:

m <= c × value of the bank

In both cases, the constraint is a collateral constraint

- Here, firms need collateral for intra-period loans
- In GKK, depositors at banks must be able to get their hands on sufficient collateral.

The question is how sensitive are the findings to the form of the constraint?

Collateral

- In the set-up of the model, loans to private entities and loans to the U.S. government are considered equally good collateral.
- Perhaps in reality, U.S. bonds are better collateral
  - Less default risk
  - Less private information about the value of the asset
- This may alter the quantitative analysis of the effects of issuing debt, and of emerging markets' holdings of reserves, on the world interest rate.
- Not even all U.S. government debt is equal
  - During the March 2020 "dash for cash", short-term debt was much preferred to long-term US bonds or government agencies.
  - QE and QT change the liquidity of gov't. liabilities.

Collateral Held by Borrowing Firms?

- In the model, borrowing firms hold no liquid assets
- The collateral is only in the form of physical capital, some portion of which can be seized by creditors in the event of default.
- Borrowing firms might want to hold liquid assets as a hedge against downturns
  - This may be another role that U.S. government debt plays, as a liquid asset that can be held as insurance in the case of bad productivity realizations.

Public Debt and Real Interest Rates

- In practice, historically the link between debt issuance by the U.S. government and real interest rates has been weak.
- Why? I think it's necessary to understand how monetary policymakers react to pressures on interest rates.
- While the analysis may be aimed at the "long-run", in practice, monetary policy has an influence over real interest rates for an extended time:
  - Recent work has suggested that nominal price adjustment can be quite prolonged under staggered price setting and pricing "complementarities".
  - The interaction of slow price adjustment and interest-rate smoothing leads to prolonged effects on real interest rates.

Tradeoffs

- In this context, we need to take into account the tradeoffs facing monetary policymakers.
- For example, debt issued by the U.S. Treasury during deep recessions, such as the COVID recession, might be accompanied by easier monetary policy and therefore an extended period in which real interest rates barely rise.
- But large deficits during “good times”, for example large tax cuts during booms, might lead to more immediate and prolonged higher real interest rates.

Policies in Emerging Markets

- Since real exchange rates are not constant, emerging markets have independent monetary policies that can influence real interest rates in their own countries.
- Reserve holdings can influence economy beyond their use in private bailouts. Especially, they act as a liquid buffer to reduce the risk of sovereign default.
  - Lower probability of default affects interest rates through macroeconomic channels
  - Also reduces the expropriation risk (corralitos) and so may influence real interest rates for private transactions.

Conclusions

- Perhaps it is too early to draw reliable quantitative conclusions, but the paper provides an important building block.
- The paper is a great contribution, especially in terms of modeling of the distributional effects of default on privately issued loans.
- It introduces new channels to consider when examining the effects of reserve accumulation and debt issuance.
- In particular, we must pay attention not only to the macro consequences of *sovereig*n defaults, but also the consequences of *business failures* and defaults.