

Discussion of

Gone With The Wind: Monetary Policy and The Global Financial Cycle

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This Project

► Questions:

- * How effective are monetary and macroprudential policies against global financial cycles?
- * From Trilemma to Dilemma?

► Approach: Dynamic SOE model with an international banking sector.

- * UIP deviations + exposure to foreign financial shocks

► Main Results:

1. Trilemma persists: no free capital mobility, fixed ER and independent MP at the same time.
2. Dilemma also present: fluctuations in the ER cannot fully absorb global shocks.
3. Welfare gains from macroprudential policies.

My comments

1. UIP deviations: Narrative
2. UIP deviations: Modeling
3. Trilemma vs Dilemma
4. Other comments

#1. UIP deviations: Narrative

	Composite Risk			Unpacking Composite Risk		
	UIP Premium	IR Differential	ER Adjustment	UIP Premium		
	(1)	(2)	(3)	(4)	(5)	(6)
Inflows/GDP _{it-1}	-0.001 (0.001)	-0.001* (0.001)	0.000 (0.001)	-0.002* (0.001)	-0.002 (0.001)	-0.001 (0.001)
Log(VIX) _{t-1}	0.051*** (0.007)	0.027*** (0.007)	0.024*** (0.007)	0.054*** (0.005)	0.057*** (0.005)	0.054*** (0.005)
Composite Risk _{it-1}	0.052*** (0.015)	0.089** (0.037)	-0.037 (0.030)			
Government Policy Risk _{it-1}				0.020*** (0.005)		0.014*** (0.005)
Confidence Risk _{it-1}					0.023*** (0.004)	0.020*** (0.004)
<i>R</i> ²	0.1948	0.1872	0.0468	0.1540	0.1641	0.1691
Observations	3427	3427	3427	3427	3427	3427
Number of Currencies	22	22	22	22	22	22
Currency FE	yes	yes	yes	yes	yes	yes

Notes: * $p < 0.10$ ** $p < 0.05$ *** $p < 0.01$. Time clustered standard errors in parentheses. Note that given low clusters due to data availability, we cannot double cluster in this regression. The UIP premium and expected exchange rate changes are measured using Consensus Forecast.

UIP deviations in EM: Composite, Gov. Policy and Confidence Risks

Source: Kalemli-Ozcan & Varela (2022)

#1. UIP deviations: Narrative

- ▶ **In this paper:** UIP deviations from "efficiency costs from taking deposits from foreign HHs".
- ▶ **Empirical evidence** suggests that **uncertainty, country risk, and investors' risk-aversion** are the main sources, especially in EM.
 - * Kalemli-Ozcan & Varela (2022), di Giovanni et al. (2021), Avdjiev et al. (2019), Du et al. (2018), Jian et al. (2021), etc.
- ▶ **Theoretical:** financial contracts are less enforceable across than within borders
 - * Other DSGEs already adopt this: Akinci & Queralto (2022), Aoki, Benigno & Kiyotaki (2018), Eguren-Martin (2020), Cesa-Bianchi, Eguren-Martin & Ferrero (2023), etc.
 - * Supported on deposit insurance only for locals, or different legal systems between EM and AE.
- ▶ Perhaps best to follow this narrative and stay close to the literature.

#2. UIP deviations: Modeling

- ▶ **In this paper:** Efficiency costs from foreign deposits are given as

$$\chi_t^b = \frac{\kappa^b}{2} x_t^2 Q_t k_t^b, \quad \text{where } x_t = \frac{\epsilon_t d_t^*}{Q_t k_t^b}$$

- ▶ This is used mostly for households dealing with foreign bonds (Glocker & Towbin, 2012)
- ▶ Could we get similar results with a simpler formulation?

#2. UIP deviations: Modeling

From Cesa-Bianchi, Eguren-Martin & Ferrero (2023)

- ▶ After issuing deposits, banks can default and divert a fraction of their assets

$$\theta(D_{it} + (1 + \gamma)Q_t D_{it}^* + N_{it})$$

- * Foreign funds are harder for creditors to recover: $\gamma > 0$
 - * Soundness of borrowers harder to monitor across borders.
- ▶ UIP deviations arise endogenously: $\mu_t^* = \mathbb{E}_t \left[\Omega_{t+1} (R_{t+1} - \frac{Q_{t+1}}{Q_t} R_{t+1}^*) \right] = f(\gamma)$
 - ▶ Perhaps check if the results hold with this simple and widely used formulation.
Easier to link them to the literature and policy debate.

#3. Trilemma vs Dilemma

- ▶ The results are in line with a '**dilemma**' (good!)
 - * "[...] adopting a **floating ER cannot fully buffer** the effects of a global financial shock".
 - * Rey (2015) says that a floating ER is not enough, but it could partially absorb shocks.
- ▶ Interesting to focus on the **macroprudential policies** to mitigate the trade-off
 - * Large spillovers from US monetary policy and...
 - * ... UIP deviations are already well-studied and modelled.

#4. Other comments

- ▶ Explore other policy tools?
 - * On the transmission channel: limiting credit growth and/or leverage during the upturn.
 - * Open Market Operations to sustain the exchange rate.
- ▶ Closer look at the Global Financial Cycle?
 - * Related to monetary conditions in the US, but also to changes in **risk aversion** and **uncertainty** (Bekaert et al. 2012, Miranda-Agrippino & Rey 2012, Bruno & Shin 2013).
- ▶ Very rich machinery and an interesting topic!
 - * Can be used to tackle relevant policy questions in international macro-finance.