Discussion of Financial Considerations in a Small Open Economy Model for Mexico

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Two very welcome features

1. Financial frictions for emerging market economy
2. Interbank market
ultimate savers

interbank market

deposit banks

investment banks

impatient entrepreneurs

foreign lenders
Main issues

1. Where should we locate financial frictions?

2. What type of frictions?

3. Foreign lenders and capital flows
Where should we locate financial frictions?

- This paper: everywhere

- Baseline model e.g. Gertler-Karadi (GK): friction between 
  depositors and banks (no interbank market)

- Classic Holmstrom and Tirole: two-sided friction

- Key point to capture in two-sided frictions: banks more 
  leveraged than household and/or entrepreneurs
What type of frictions?

- GK: agency/moral hazard friction + endogenous net worth → Feedback with asset prices

- This paper

  1. monopolistic competition + sticky interest rates
  2. exogenous net worth

- Key feature to capture: banks collateralize long-term assets and borrow short term → Mismatch

- Maturity endogenous
Foreign lenders and capital flows

- Most of capital flows ("hot money") channeled through banks. Why? Difficult to acquire local ETF

- Informational frictions: lending is short term + foreign currency → Both endogenous

- This paper: channel of capital flows is exogenous.
Leverage is endogenous

1. **No** concept of leverage for banks
2. Leverage **constant** for households and entrepreneurs