Discussion of Menna and Tobal’s "Financial and Price Stability in Emerging Markets: The Role of the Interest Rate"

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The Big Picture

- Post-2008 policy consensus:
  - Rapid credit growth may cause crisis
    - Crisis $\implies$ high unemployment, low output
    $\implies$ political economy consequences (populism etc)
  - Central banks cannot mop up
  - Central banks must prevent next crisis
Policy Questions

- How to define excessive credit growth?
- Tools to prevent it:
  1. Macroprudential policy
  2. Standard monetary policy:
     - “leaning against the wind”
Menna and Tobal (2017)

- SOEs: “lean against the wind” backfires
- If CBank increases interest rates...
  - Domestic credit contracts
  - Foreign credit expands
  - Capital inflows effect dominates
- CBank should \textit{lower} interest rates
Comments

- Great insight!
- Policy implications very important
- Potentially influential paper
- Execution needs more work, different approach
Two periods model

- Period 1:
  - DSGE
  - Borrower, savers
  - Savers can borrow from abroad

- Period 2:
  - Output high or low depends on period 1 credit
- Look for clean theory paper
  - Simplify model of period 1
  - Focus on key ingredients
- Separate insights for *open* economies
- from *emerging* economies
Insights for *open* economies

- When do flexible exchange rates allow to "lean against the wind"?
- Interact "leaning against the wind" with capital controls
## Capital Controls

Table 1
Capital controls: mean, standard deviation, and correlations.

<table>
<thead>
<tr>
<th>Statistic</th>
<th>All countries</th>
<th>Developed countries</th>
<th>Emerging countries</th>
<th>Low-income countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Controls on capital inflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.31</td>
<td>0.07</td>
<td>0.35</td>
<td>0.51</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>0.07</td>
<td>0.03</td>
<td>0.08</td>
<td>0.08</td>
</tr>
<tr>
<td>Correlation with output</td>
<td>0.00</td>
<td>-0.07</td>
<td>0.07</td>
<td>-0.04</td>
</tr>
<tr>
<td><strong>Controls on capital outflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.37</td>
<td>0.10</td>
<td>0.40</td>
<td>0.60</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>0.07</td>
<td>0.05</td>
<td>0.07</td>
<td>0.07</td>
</tr>
<tr>
<td>Correlation with output</td>
<td>0.00</td>
<td>-0.07</td>
<td>0.03</td>
<td>0.04</td>
</tr>
<tr>
<td>Correlation between controls on inflows and</td>
<td>0.31</td>
<td>0.19</td>
<td>0.32</td>
<td>0.43</td>
</tr>
<tr>
<td>controls on outflows</td>
<td></td>
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</tr>
</tbody>
</table>

Note: Sample 1995–2011, 22 developed countries, 36 emerging countries, and 20 low-income countries. All moments are computed country by country, then averaged across countries. Second moments are computed using cyclical components, as defined in Section 2.

Framework to evaluate "leaning against the wind"

- Why "leaning against the wind"?
  - monetary policy has broad effects
  - it “gets in all the cracks”, Stein (2013)
- Need costs from regulatory arbitrage in the model
Insights for *EME* economies

- EMEs have larger informal sector
- EMEs have less developed financial sector, less shadow banking?
- Are EMEs more or less exposed to regulatory arbitrage?
Shadow banking is 1st order risk

- U.S. in 2006
  - 13 of top 15 subprime lenders were non-banks (Demyanyk and Loutskina 2016)
    - New Century, Countrywide, WMC Mortgage, First Franklin, Ameriquest, Option One, Accredited Home Lenders, American General Finance, BNC Mortgage...
  - All defaulted or were restructured post-2007
Non-banks are back...

Source: Gete and Reher (2017)
The new non-banks

- Quicken Loans, PennyMac, PHH Mortgage, Freedom Mortgage, Walter Investment, Caliber Home Loans, Nationstar Mortgage, Prospect Mortgages, Stearns Lending, Loan Depot...

- Are they a risk for financial stability?
  - Most are private
  - Fintech makes shadow banking easy
Conclusions

- Bright idea:
  - "leaning against the wind" can work differently in open economies

- Future work: characterize the result, relate to capital controls, add costs from regulatory arbitrage