Discussion of: China's Financial Conundrum and Global Imbalances by McKinnon-Schnabl

Ricardo J Caballero

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First impressions…

- There are many things to like about this paper
  - Approach: Its perspective is global in nature
  - Policy: Exchange rate is not the main issue behind imbalances (…although it is not true that everybody thinks otherwise…)
    - If China were to fix its exchange rate, it could well experience capital outflows in the short run
    - Moreover, I don't believe that macroeconomic policy in general is the "solution" to global "imbalances"

My Reading of their paper…

- $i^{ch} >> i^{us} + E[\Delta e]$
  - Low i^{us} due to subprime
  - Negative $E[\Delta e]$ due to “good” politics and bad economics
  - High i^{ch} due to sterilization
- Problem
  - $CF(i^{ch}-(i^{us} + E[\Delta e]))$ with $CF' >> 0$
  - $\pi(CF)$ with $\pi' >> 0$ due to imperfect sterilization

My Reading of their paper…

- Potential solutions:
  - Lower i^{ch}
    - Not much space while $\Delta e<0$ and i^{us} low
    - Also, $\pi(CF, i^{ch})$ with $\pi_i > 0$
  - $\Delta e=0$
    - Large once and for all appreciation… not a good idea since central and commercial banks are exposed to an appreciation
    - (*) Fix exchange rate at current level

      … and then move on to fix imbalances with fiscal policy

Concerns…

- The underlying model?
  - What is the inflation channel? I.e the $\pi(CF)$ function
    - A rise in expenditure? They talk about overheating…
    - If so, why doesn't it show up in the current account? (no positive terms of trade shock)
    - Why fiscal better than monetary?
- P17… "Remember, however, that behind (the overheated Chinese economy and the bubble in commodity prices) is unduly loose US monetary policy…"
  - They attribute too much power to central banks…
  - I will sketch a market / non-monetary based alternative… (reality probably in between)

An Alternative View (CFG)

- The world has a chronic excess demand for assets and the US is one of the prime producers of these
- Subprime shock destroyed a share of these assets
- Equilibrium real rate plummets and oil prices rise due to asset demand

An Alternative View (CFG)

- Two implications:
  - Asset supply effect of increase in Poil is small (low inventories) relative to increase in asset demand due to higher income in oil producing economies
    - Equilibrium real interest rates fall further
    - Limits global rebalancing, although gives rise to local bubbles in some EMEs
  - Endogenous supply shock from oil price increase
    - Raises inflation, particularly in EMEs
    - Optimal partial monetary accommodation

Policy Implications from Alternative View

- Best mechanism to reduce “supply” shock and inflation:
  - Financial development and recovery
  - Tax oil financial investments would help with inflation but it could complicate the US unless financial recovery happens in tandem
- What about China?
  - Same – it needs a recovery of US financial system
  - If that happens, and fixed exchange rate, it would probably experience a capital outflow in the short run

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