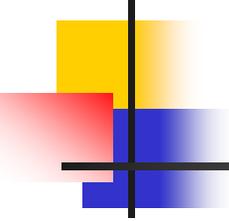


# Discussion of: China's Financial Conundrum and Global Imbalances by McKinnon-Schnabl

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Ricardo J Caballero

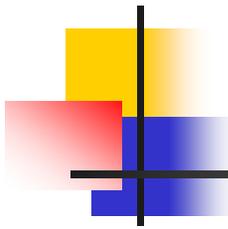
BIS Annual Conference, Luzern 2008



# First impressions...

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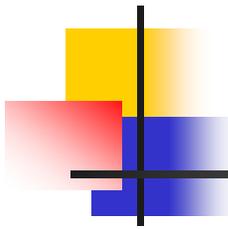
- There are many things to like about this paper
  - Approach: Its perspective is global in nature
  - Policy: Exchange rate is not the main issue behind imbalances (...although it is not true that everybody thinks otherwise...)
    - If China were to fix its exchange rate, it could well experience capital 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...

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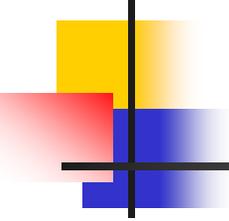
- $i^{ch} \gg i^{us} + E[\Delta e]$ 
  - Low  $i^{us}$  due to subprime
  - Negative  $E[\Delta e]$  due to “good” politics and bad economics
  - High  $i^{ch}$  due to sterilization
- Problem
  - $CF(i^{ch} - (i^{us} + E[\Delta e]))$  with  $CF' \gg 0$
  - $\pi(CF)$  with  $\pi' \gg 0$  due to imperfect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



# My Reading of their paper...

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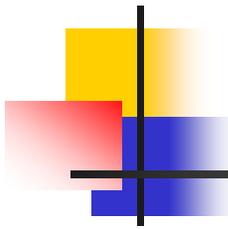
- Potential solutions:
  - Lower  $i^{ch}$ 
    - Not much space while  $\Delta e < 0$  and  $i^{us}$  low
    - Also,  $\pi(CF, i^{ch})$  with  $\pi_i > 0$
  - $\Delta e = 0$ 
    - Large once and for all appreciation... not a good idea since central and commercial banks are exposed to an appreciation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



# Concerns...

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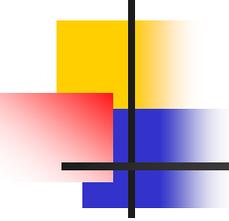
- The underlying model?
  - What is the inflation channel? I.e the  $\pi(\text{CF})$  function
    - A rise in expenditure? They talk about overheating...
    - If so, why doesn't it show up in the current account? (no positive terms of trade shock)
    - Why fiscal better than monetary?
- P17... "Remember, 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)

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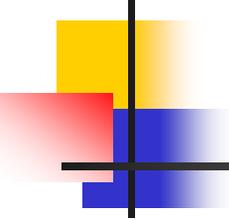
- The world has a chronic excess demand for assets and the US is one of the prime producers of these
- Subprime shock destroyed a share of these assets
- Equilibrium real rate plummets and oil prices rise due to asset demand



# An Alternative View (CFG)

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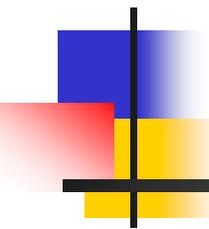
- Two implications:
  - Asset supply effect of increase in  $P_{oil}$  is small (low inventories) relative to increase in asset demand due to higher income in oil producing economies
    - Equilibrium real interest rates fall further
    - Limits global rebalancing, although gives rise to local bubbles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



# Policy Implications from Alternative View

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- 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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