Valentina Bruno and Hyun Song Shin
"Capital Flows and the Risk-Taking Channel of Monetary Policy"

Discussion by

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Summary of Bruno and Shin

- Lower interest in AE $\Rightarrow$ Increased capital inflow into EE
- EE currency appreciation $\Rightarrow$ Improved EE balance sheets $\Rightarrow$ Amplified capital inflow
- VAR analysis: Lower Fed funds rate stimulates cross-border capital flows

My points

- (Only *real* interest rates and exchange rates – arguably not about monetary policy)
- Standard open-economy macro: UIP
- EE balance sheets
- Optimal risk-taking
- Regulation and macro-prudential policy

Standard open-economy macro: UIP

- Lower AE interest rate, given EE interest rate ⇒ increased interest-rate differential ⇒ *incipient* capital inflow ⇒ EE currency appreciation ⇒ expected EE currency depreciation
- Expected EE currency depreciation = Interest-rate differential
- EE policy response?
  - Appreciation dampens exports, tradable sector; stimulate nontradable sector?
  - Lower policy rate, less appreciation
- In practice, EE authorities often intervene to resist initial appreciation; resist UIP
- ⇒ Increased capital inflows: Foreign investors gain from both interest-rate differential and eventual appreciation

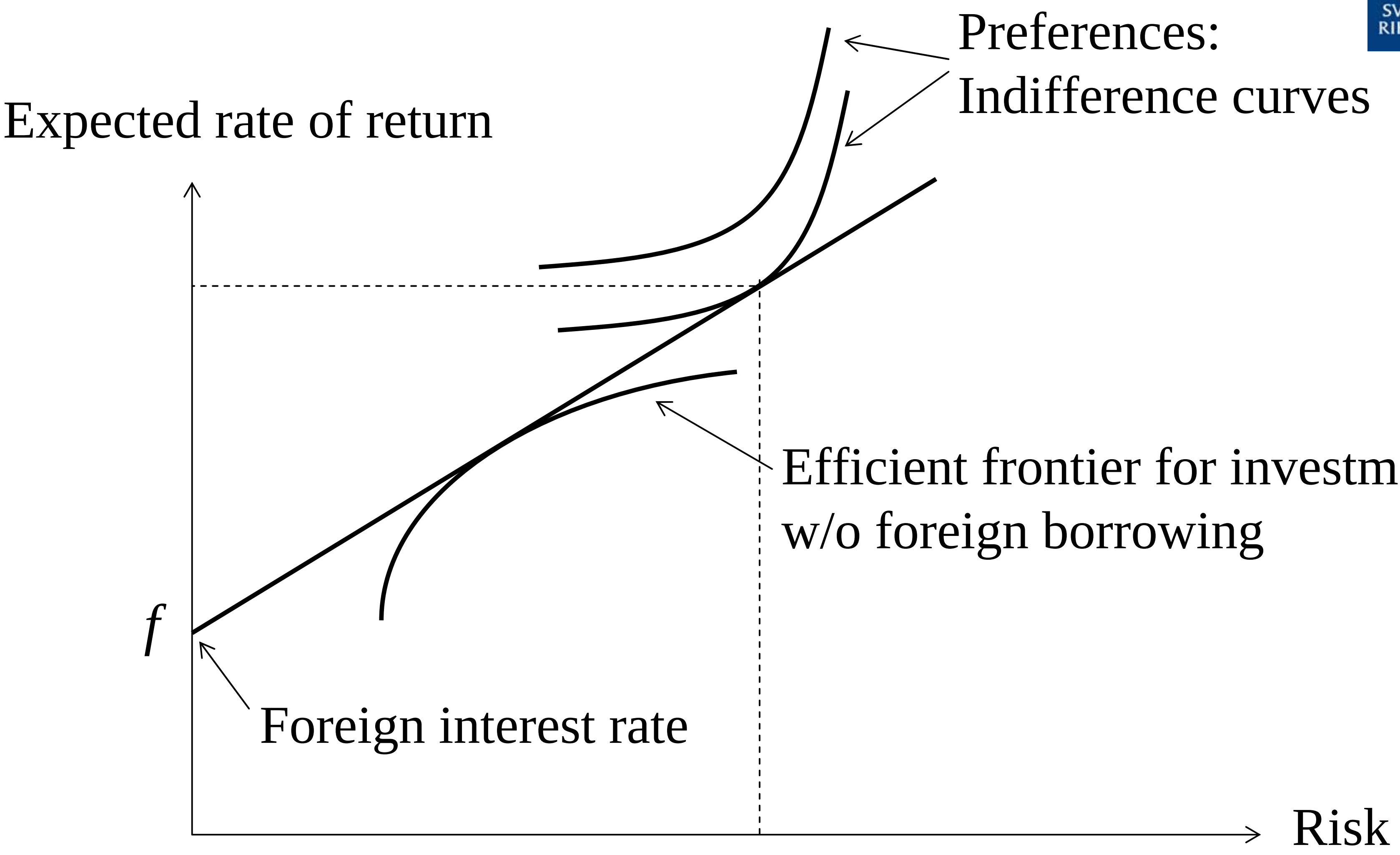
EE balance sheets?

- Initial improvement from appreciation (in B-S)
  - Expected to deteriorate (expected depreciation) (missing in B-S)
  - Deterioration from lower profits in tradable sector (missing in B-S)
- Full general equilibrium effects?

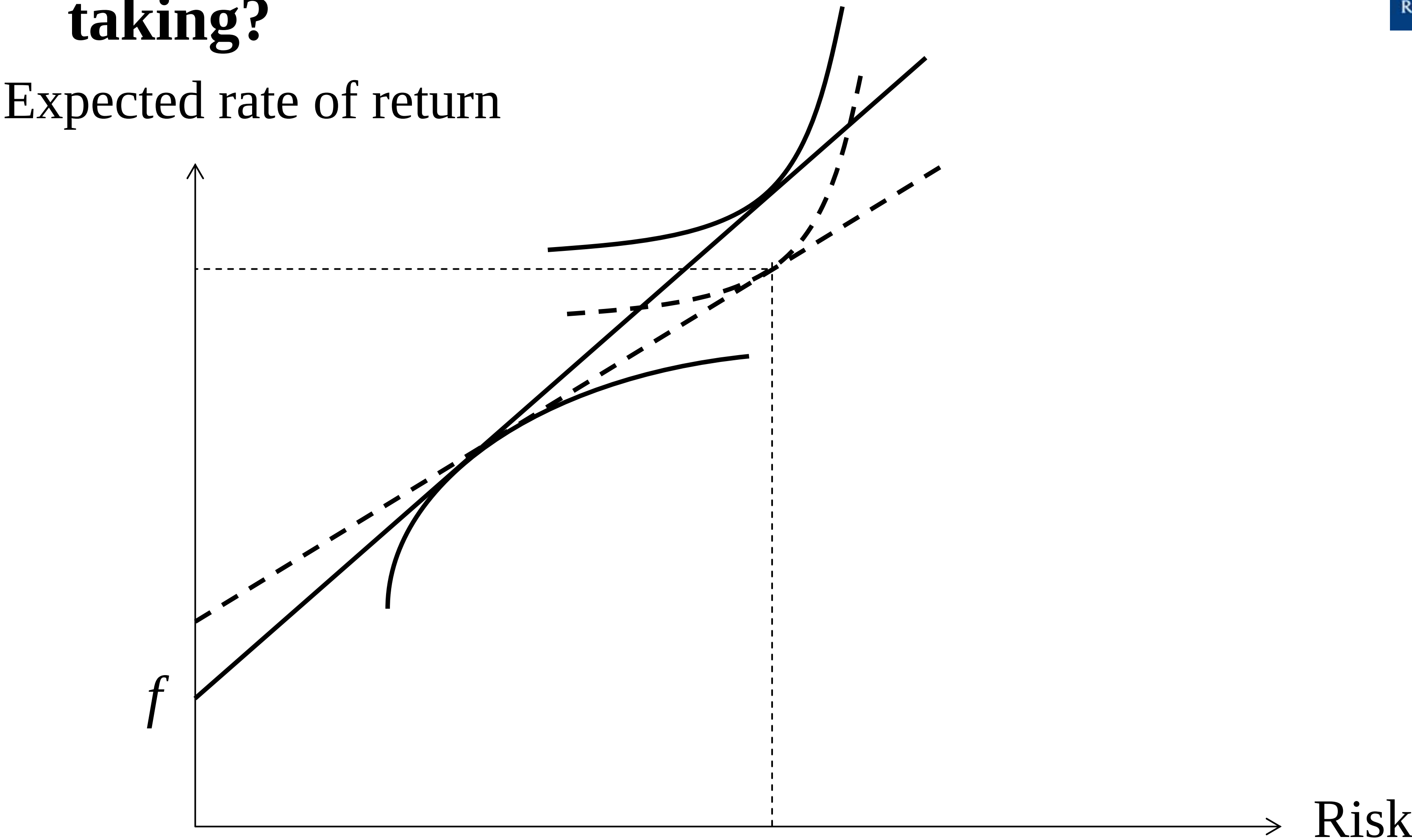
Risk-taking?

- Increased interest-rate differential $\Rightarrow$ increased expected rate of return
- Tradeoff between expected rate of return and risk
- More or less risk-taking depends on preferences
- What is optimal risk-taking?
- Actual risk-taking too much or too little?

Expected rate of return and optimal risk-taking



Lower foreign interest rate: More or less risk-taking?



Risk-taking?

- Increased interest-rate differential, increased expected rate of return
- Tradeoff expected rate of return – risk
- More or less risk-taking depends on preferences
- What is optimal risk-taking?
- Actual risk-taking too much or too little?
- What is the market failure/externality/distortion?
- ”Measured” risk vs. ”true” risk?

Regulation and macro-prudential policy?

- Model has a binding VaR restriction
- Regulation and macro-prudential policy not considered
- How does the model work with capital requirements, minimum NSFR, etc.?

Not only emerging economies?

- Swedish policy rate and o/n rate high, 1.5 % (against my dissent), much higher than the Eonia and Federal funds rates
- Cheaper for Swedish banks to fund themselves by short-term borrowing in EUR and USD, swap to SEK, and finance SEK loans this way
- Creates dependence on short-term foreign funding and possible vulnerability (Riksbank Financial Stability Report)
- Example of high domestic interest rates causing vulnerability and possible financial-stability problem