# Financial Crises and Lending of Last Resort in Open Economies

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Discussion
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# Quick Summary of Result

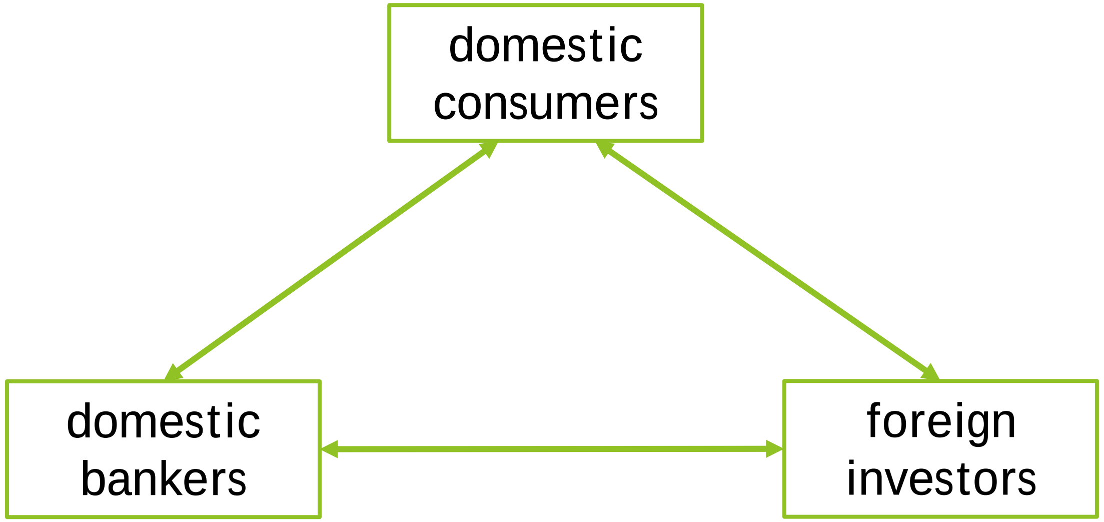
What's the purpose of reserve accumulation in emerging economies?

- it's to prevent [expectations-driven] financial crises

  or, using more colorful language,
  to ward off speculative attacks

- argument might be obvious to policymakers,
  but surprisingly difficult to work out carefully
- and doing it represents a very significant contribution

# Agents & Financial Relationships




**friction:**
borrowing constraint that depends on exchange rate

**friction:**
trade dollar bonds only

# Quite a Few Model Ingredients

1. model of balance sheet crises a la Krugman (1999)
2. power up amplification to obtain multiple equilibria
3. crisis risk concentrated in banks b/c households risk-averse
4. public liquidity provision rules out bad equilibrium
5. this reduce risk exposure of banks
6. however, low fiscal capacity limits liquidity provision
7. but foreign reserves provide more fiscal credibility

Main innovations: 5., 6. and 7.

# Key Contribution

Key contributions:

5. liquidity provision … reduces risk exposure of banks
    - nice insight, follows Guido's "moral hazard misconceptions"
6. however, low fiscal capacity limits liquidity provision
7. reserves provide fiscal credibility
    - arguments 6. and 7. also hold in simpler models of multiple equilibria & liquidity provision (e.g. bank runs)

→ a more general insight of the model

# Some Comments

**Some Comments:**

- model worked out very carefully and a pleasure to read

- novel results are a bit back-loaded
  - focus more attention on final section
  - derive additional ex-ante results

# Policy Implications

In the paper, foreign reserve accumulation addresses the problem
…but let's ask two broader questions:

**1) Is this the main reason for reserve accumulation?**

- in some countries probably not (e.g. China), but for some it is

**2) Is reserve accumulation the optimal policy?**

**As usual, start with the first-best policy:**

- alleviate balance sheet constraints → hard to do
- create international markets for domestic currency
  - over the past two decades: much progress (e.g. Warnock…)

# Policy Implications: Foreign Currency Debt

**Second-best policies:**

**Main problem** = that foreign currency debt generates multiple equilibria

→ natural to regulate foreign currency borrowing

→ akin to pecuniary externality literature (Lorenzoni, 2008; Korinek, 2011, 18)

→ similar solutions (e.g. Pigovian taxes) should work

# Distribution

**Distributive effects:**

- costs of reserve accumulation borne by households
- benefits accrue to bankers
  - large transfer if runs and liquidity support do happen
  - [in model, presence of reserves means they won't need to be used under certain parameter configurations]
- the distribution deserves at least some discussion

# The Cost of Reserve Accumulation

**Ex-ante costs** are not explicitly discussed in the paper

In practice: reserves obtained via large CA surpluses

→ capital flowing “uphill”

→ significant costs to taxpayer from interest rate differential

**Critical question:** has the government comparative advantage in holding reserves? (see also Jeanne-Korinek, 2013)

- if not, induce the private sector to hold reserves (i.e. switch to less risky portfolio allocations)
- this puts the cost of insurance on those who create the risk