

Discussion of:
“Managing Financial Integration”
by Fernando Broner and Jaume Ventura

Mark L. J. Wright
Federal Reserve Bank of Minneapolis
Stanford University

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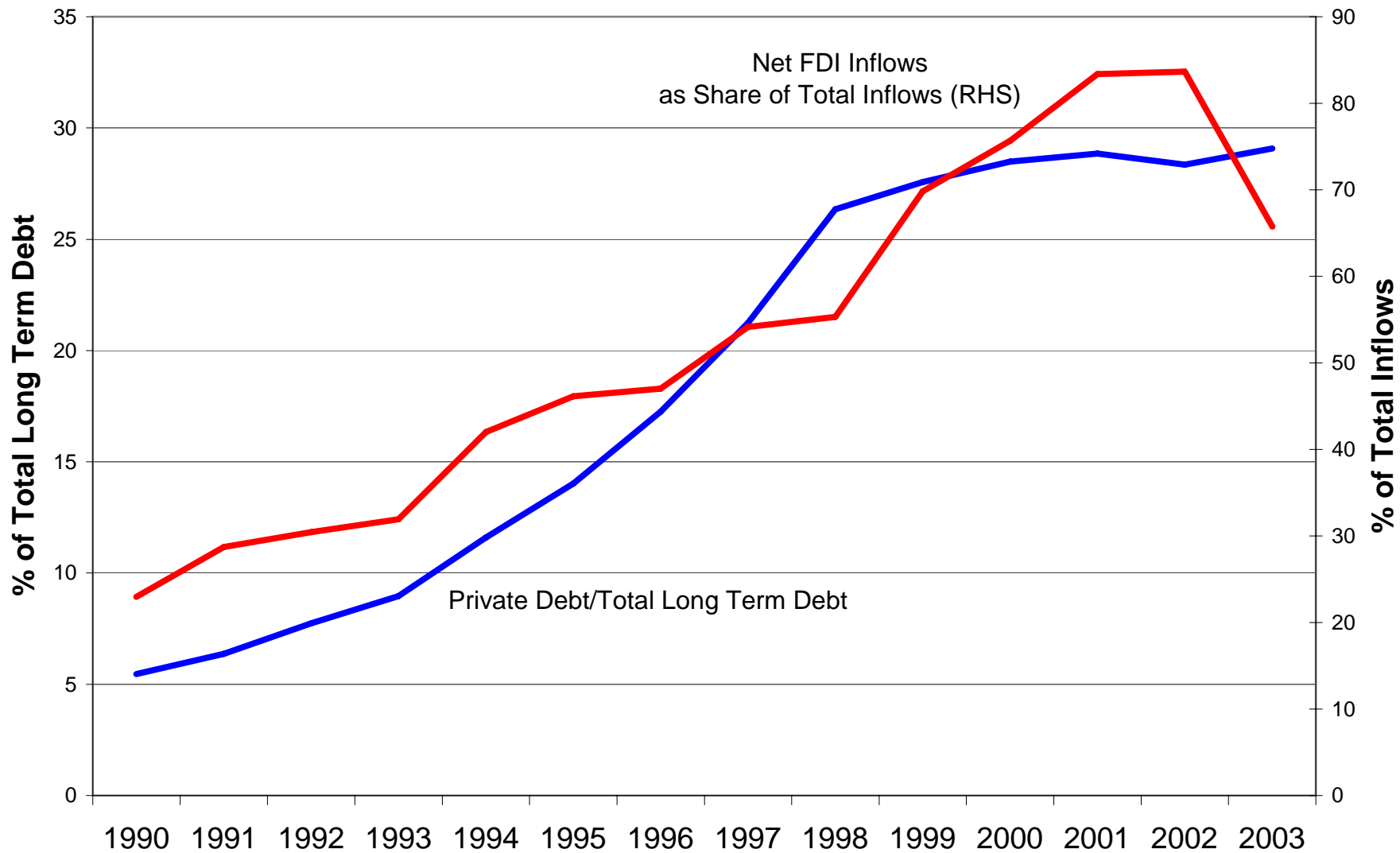
The Benefits of Financial Globalization

- The past decade has seen major changes in the way economists and policymakers view financial globalization
- The benefits of financial globalization now thought to be smaller: Jeanne & Gourinchas (2004)
- The costs now thought to be larger, because of:
 - restrictions it places on macroeconomic management (Obstfeld and Taylor 2004)
 - increases exposure to crises (Ariyoshi et al 2001 and many others)
 - interaction with other financial market frictions (Jeske 2001, Kehoe & Perri 2004, Wright 2004)
- Official position on capital controls has also shifted dramatically (IMF 2003)

Current Paper

- Like Kehoe & Perri (2004) and Wright (2004), studies the effect of financial market globalization on international financial market outcomes when there are enforcement constraints
- Where the current paper differs is in the details:
 - integration increases because of decline in trade costs
 - government repays out of a concern for maintaining domestic financial markets
 - government only decides whether to default/not default
 - version of market structure allows for bubbles
- But the fundamental forces in the model are the same:
 - separation of decision to borrow from decision to default leads to inefficient borrowing
 - government intervention in capital markets (capital controls?) can be beneficial

Private Capital: Stocks and Flows



Private Capital Flows

- Separation of borrowing and default decisions is becoming more important
- Capital flows to developing countries have shifted towards private sector borrowers. Over past decade:
 - Private share of debt stock rose from 5% to more than 25%
 - FDI as share of capital inflows more than tripled

In My Discussion

- Present a variant on Broner-Ventura model in which globalization occurs through reduction in a tax on capital flows (a reduction in capital controls)
 - simplifies analysis slightly
 - reinterpret key result of paper: optimal capital controls
- Discuss how this relates to Jeske (2001), Kehoe & Perri (2004) and Wright (2004)
- Show how results would differ (in some cases very substantially) if:
 - nature of trade differs
 - incentives for repayment differ
- Punchline: government intervention in international capital markets often justifiable, but ... form of optimal intervention sensitive to precise form of financial market imperfection

An (Even More) Stylized Model

- Consider variant of simple static model of paper
- Two countries – home and foreign – populated by unit measures of residents
- Aggregate country endowment is equally likely to be high ($1 + y$) or low ($1 - y$) and is perfectly negatively correlated
 - either always default or never default
- There is idiosyncratic risk: half of each countries population gets $1 \pm y + x$, and half gets $1 \pm y - x$
- residents privately trade state contingent securities anonymously

Stylized Model

- Trade between countries (that is, capital flows) are subjected to a tax of rate $\tau - 1 > 0$
 - rebated to consumers: don't have to keep track of resources used up in trade
- After realization of uncertainty, a government can "default"
 - all obligations go unfulfilled/no domestic financial trade takes place
 - government can undertake no other actions/policies
- Benevolent governments repay debts if welfare gain from domestic trade offsets resources paid overseas
 - simple way of getting at intuitive idea that governments repay debts in order to minimize domestic financial disruption

Stylized Model

- Focus on symmetric equilibria
- If enforce contracts
 - same wealth and facing same prices, all residents have same consumption: $1 \pm c$
 - as long as τ not "too large", c solves

$$\frac{1}{1+c} = \frac{1}{\tau} \frac{1}{1-c}$$

$$1+c = \frac{2\tau}{1+\tau} > 1$$

- if do not enforce contracts, all agents in autarky

Stylized Model

- After realization of uncertainty, will enforce contracts iff

$$\ln \left(\frac{2\tau}{1 + \tau} \right) \geq \frac{1}{2} \ln (1 + y + x) + \frac{1}{2} \ln (1 + y - x)$$

- It is easy to see that, all else equal:
 - increasing y makes default more likely: the greater are international capital flows, the more tempting it is to default
 - increasing x makes default less likely: the greater are domestic gains from trade, the less tempting is default
 - increasing τ makes default less likely: decreasing international capital flows makes default less attractive
- This sets up key tradeoff: lower are capital controls (closer τ is to one), more gains from trade are exploited, but more likely is default
 - potential for optimally positive capital controls

What is Going On?

- As residents are small, they do not take into account the effect of their borrowing decisions on the likelihood of government default
- Without capital controls, they tend to "borrow too much": government may default
- If parameters such that international flows are large enough relative to domestic flows, only equilibrium is autarky
- Appropriately designed, capital controls (taxes) bind residents to only borrow amounts that governments would want to repay
- One can also show that this is an equilibrium of Nash game between governments

Relationship to Other Approaches

- Basic intuition is very clear. Not surprisingly, result carries over to many alternative frameworks in which default/borrowing decisions are separated
- In Wright (2004), I study private capital flows with public default risk in a model where reputation provided repayment incentives
 - for the same reason, positive capital controls optimal
 - see also Fernandez-Arias and Lombardo (2000)
- Conversely, when borrowing and default decisions are made by the same agent (sovereign or resident), reductions in capital controls/trade costs, are welfare improving
- Consider Kehoe-Levine-Kocherlakota-Alvarez-Jermann reputation framework
 - equilibrium allocations attain solution of social planners problem
 - reduction in trade costs expand feasible set of allocations: global welfare must rise

Other Approaches: Enforcement Technology _____

- Suppose sovereigns were induced not to default by threat of trade sanctions?
 - conjecture that reductions in trade costs (which increase gross trade) allow for more enforcement of contracts
- Jeske (2001) studies environment in which residents can borrow and default, and are punished by exclusion from international, but not domestic, markets
 - reputation mechanism is weakened because residents can borrow internationally using other residents as intermediaries: too little borrowing
 - Wright (2004) shows that international capital flow subsidies (not taxes) attain constrained optimal capital flows in this model
 - intuitively, subsidies increase value of access to international markets and discourage default

Conclusions

- Should we, as economists, be encouraging developing countries to liberalize their capital accounts?
- Much recent work, including this paper, says "maybe not":
 - gains from doing so maybe smaller than previously thought
 - costs in terms of exposure to crises, loss of policy autonomy may be high
 - also, as in this paper, costs may include inefficiencies due to interaction with other distortions like limitations on enforcement
- How should capital accounts be regulated? Answer extremely sensitive to assumptions:
 - in current paper, Kehoe & Perri (2004) and Wright (2004), capital taxes limit borrowings to self-enforcing levels
 - in model of Jeske (2001), capital subsidies are efficient