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International Financial Crises

Comments on presentations by Ricardo J. Caballero and Carmen M. Reinhart

Guido Lorenzoni

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International Financial Crises

- Combination of several elements:
  - capital flight
  - currency devaluation
  - banking crisis
  - domestic recession
- Emerging economies: crucial lab for financial crises
- 2008 crisis came less as a surprise to international economists

Approaches

- Different approaches to attack the issue
- RC: models to build insight, capture crucial trade offs
- CR: look at data to identify basic facts and regularities

Common themes: credit markets

- Before 90s focus on fiscal/monetary instability (Krugman 1979, Obstfeld 1994)
- CR/RC: to understand volatility in emerging markets central role of credit markets

- Kaminski-Reinhart (1999): notion of *twin crisis*
  - tight connection between banking and currency dimension
  - role of financial liberalizations and credit booms
- Caballero-Krishnamurthy (2001, 2002, 2003)
  - domestic and international collateral
  - inefficiency in dollar debt (Lorenzoni 2008, Bianchi 2011)

Common themes: a global view

- To understand crises we need to understand the global context
- A storyline:
    - US provides safe assets to rest of the world
    - 1997-1998 East-Asian crisis: emerging economies get scared, demand more safe assets (including official reserves)
    - World interest rates go down
    - US financial sector has incentive to produce more safe assets (creating AAA from anything). This sets the stage for 2007-2008 crisis
    - Supply of safe assets falls, interest rates hit zero
    - Things normalize and US Treasury and central banks fill the gap, but original tensions are still there

A global view (RC)

- Global imbalances
  - Caballero-Farhi-Gourinchas (2008)
  - A model of US providing safe assets to rest of the world
  - Connect to liquidity trap, Caballero-Farhi-Gourinchas (2016)
- Some following work/issues:
  - point can be explored from a precautionary-saving view (Mendoza-Quadrini-Rios Rull, 2009)
  - the US takes risk for rest of the world, we should see US risk premia go up in 2000s (Favilukis, Ludvigson, Van Nieuwerburgh, 2017)
  - the US takes risk for rest of the world, we should see dollar depreciate in crises (Maggiori, 2017)

A global view (CR)

- Reserve accumulation
- Ilzeki-Reinhart-Rogoff (2017)
- Why do countries accumulate reserves?
- To have a tool to stabilize exchange rate when markets get nervous
- Related to past work on *fear of floating* (Calvo-Reinhart, 2000)

One difference

- RC: emphasis on safe asset shortages
  - more public liquidity is good
- CR: focus on after-crises adjustment and accumulation of public debt
  - potential for debt crisis to follow (Reinhart-Rogoff)
- In part it depends on what countries you look at
- Concerns for issuing incentives of US (Triffin dilemma, Farhi-Maggiori 2016)

Future (modeling)

- A scenario for which models still limited:
  - Emerging economy experiences capital flight and recession
    - Raise policy rate can attract back capital but worsens domestic contraction
    - Lower policy rate worsens the devaluation

- Problem 1: in simple models with floating capital flight does not cause recession (Blanchard-Ostry-Gosh-Chamon 2015, Caballero-Krishnamurthy 2005)
- Problem 2: in simple models monetary policy gets full employment, exchange rate secondary (benign neglect)
- Problem 3: what ordering of tools? fiscal policy, capital controls, currency interventions

- In models floating relaxes a constraint
- In reality it adds volatility

Future (data)

- Fast growing literature using micro data
- Much more detail on how credit markets work in emerging economies
- Some examples: Baskaya-di Giovanni-Kalemli-Ozcan-Ulu (2018), Hale-Kapan-Minoiu (2016), Williams (2017)