Discussion on "Global Financial Cycle and Liquidity Managment" by Olivier Jeanne and Damiano Sandri.

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Summary

- Interesting and insightful paper.
- Simple theory for demand of liquid asset and gross flows.
- Stylized facts on gross and net international positions and relation to level of financial development.
- Main results (normative): it is beneficial to increase size and volatility of gross capital flows.

Summary (model)

- 3-period small open endowment economy (emerging market)
- 2 assets: liquid assets and debt.
- Global financial cycle: risk appetite towards emerging market bonds is lower $\Rightarrow$ price of emerging market bond depends on foreigners discount factor.
- Financial development modelled as a limit on the amount of debt that can be issued (both from private and public point of view).

Mechanism (imperfect substitutability)

- Investment in Liquid Asset (period 0)

$$k = pb - a$$

- In period 1 foreigners might limit amount of debt rollover

$$p'b' \leq \phi$$

- When constraint binds in period 1:

$$\underbrace{a'}_{=0} + p'b = a + \underbrace{p'b'}_{=\phi}$$

- Liquid assets, a , are used when the constraint binds.

$$p'b = a + \phi$$

- Source of imperfect substitutability: Price of liquid asset is fixed while the price of Emerging market debt depends on the global financial cycle.

Normative analysis

- Global and EM social planner.
- From global point of view allocation is constrained efficient (endowment economy).
- EM social planner's welfare is decreasing with the price of EM debt and takes into account the effects that buying reserves have on debt.

$$p'b = a + \phi$$

- Effectively EM market social planner manipulates risk premium that is determined by foreign discount factor.
  - Is EM market social planner the right perspective for normative analysis?
- Logic of intervention is similar to literature on pecuniary externality (price support policy when constraint binds): accumulate as many reserve assets as possible. Limit is given by level of financial development
- Nature of intervention: distributive.

Role of reserves

- Why higher gross flows can be stabilizing?
  - There are no costs of reserve accumulation from social planner point of view.
- What would happen if reserves are accumulated to affect the exchange rate in a context of liability dollarization?
  - Accumulation of reserves associated with depreciation of the exchange rate $\Rightarrow$ increase vulnerability to global financial cycle shock when liabilities are in foreign currency.
- Accumulation of reserves is associated with lower rate of return on reserve.

Empirical implication on gross flows

- Theoretical analysis builds on the assumption that liquid assets' return is not affected by financial cycle.
- Empirical analysis: liquid assets are identified with private capital outflows.
- Private outflows is a big category in Financial Account.
  - First pass decomposition of private outflows (see Alfaro, Kalemci-Ozcan and Volosovych.(2014) or Lane and Milesi-Ferretti, (2001)):
    - FDI,
    - portfolio equity investment,
    - Portfolio debt flows (investments in bonds, debentures, notes, money market, negotiable debt instruments), other investment category includes debt-like instruments (loans, transactions in currency and deposits, financial leases, and trade credits).

Not so stabilizing gross flows

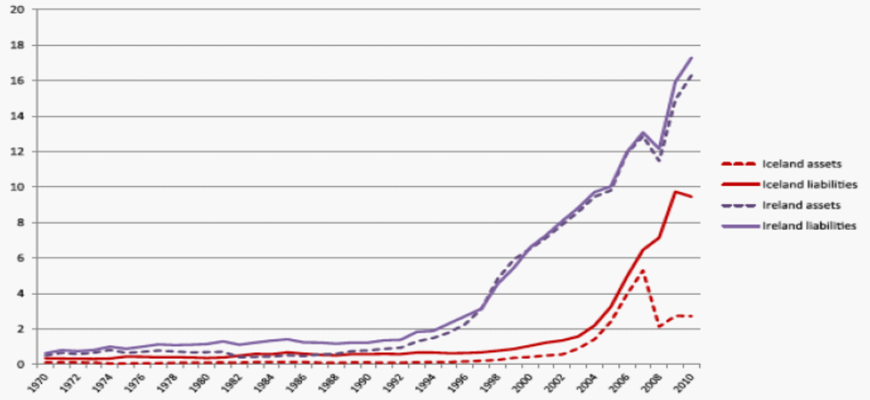

Fig. 3. Gross foreign assets and liabilities as a ratio to GDP: Iceland and Ireland.

Conclusions

- Insightful paper in its simplicity.
- More granular empirical analysis
- Extensions to capture policy trade-offs in holding reserves.