

A discussion of A Long Run Perspective on Currency Mismatch, Crises and Growth.

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- Small Open Two Sector Economy
- Risk Neutral International Investors
- T sector: competitive firms and consumers.
- N sector: firms run by overlapping generations of entrepreneurs living two periods, workers in the first period and entrepreneurs in the second one.
- Two imperfections in the N sector: borrowing constraints and systemic bail out guarantees
- N and T firms use N goods as an input.

Main Results of the paper

- Financially fragile economies grow on average faster than safe economies
- Crises materialize in equilibrium only if their probability is not too large
- Negative skewness is positively associated with growth

- Two types of externalities
 - Currency risk exposure: The cost of currency risk exposure decreases with the number of exposed entrepreneurs, because of the existence of bail-out guarantees
 - Price of N goods: The demand for N goods increases in the price of N goods. A large price for N goods raises N firms profits and thereby N firms demand for N goods
- Credit risk can be a second best policy to increase social welfare

- The N sector is the source of endogenous growth in the model. Practically, the T sector seems to be playing a big role in growth, especially in countries that have adopted export led growth strategies
- The model focuses on model driven exchange rate uncertainty, i.e. uncertainty stemming from multiple equilibria and abstracts from the possibility of exogenous shocks. That may be a large part of RER volatility
- The model assumes that binding bottlenecks are on N goods. Empirically, developing economies are often short of T goods

Discussion

Borrowing constraint and RER risk

- Credit and investment are larger under 'risky' CME than under 'safe' CME because diversion costs h are paid ex ante. They hence do not depend on the probability of $1 - u$ of exchange rate depreciation
- This generates the property that a larger probability of ER depreciation, i.e. lower u , raises capital b entrepreneurs can borrow

$$b(u) = \frac{h\delta}{u - h\delta} \text{ and } I(u) = \frac{u}{u - h\delta}$$

- With standard ex post moral hazard, the probability of ER depreciation $1 - u$ would have no impact on the borrowing capacity b
- Crisis costs ($\mu_w < 1 - \beta$) would be necessary in this case to generate multiple equilibria

Discussion

ER Self-reinforcing mechanism

- N and T sectors are separated in the model. Agents in particular cannot move across sectors
- Suppose labor can move between N and T sectors, then an expected exchange rate depreciation would move workers from the N to the T sector, thereby raising the supply of T goods and reducing that of N goods
- This will contribute to raise the relative price of N goods relative to T goods and hence can reduce the scope for multiple equilibria

- **Optimality:** Is the systemic bail-out guarantee the efficient mode of government intervention ?
- How does it compare with ex ante policies such as redistribution from old N entrepreneurs towards young N workers
- **Commitment:** If entrepreneurs contract ex ante with international investors assuming a government bail out in case of systemic default, then the government has no incentive to bail out ex post since this consists in a net transfer to international investors.
- This commitment problem can be bypassed if domestic investors hold the foreign currency denominated debt issued by N firms. To be possible, this needs that T firms do not face a constraint on borrowing from international investors.

Discussion

Dynamic Externalities

- In the model, a systemic default with government intervention does not jeopardize future developments
- In reality however, it is likely that firms borrowing capacity decreases following a systemic default due to a number of reasons such as loss of confidence (cf. today's experience) or credit market (dis)integration
- In the model, the parameter h could be made contingent on government intervention at the previous period