Financial Globalization, Financial Crises and Contagion

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Discussion:

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Objective

- Provide a model that can quantitatively match
  - net capital inflows to US prior to crisis
  - transmission of crisis from US to rest of the world

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Basic mechanism

- Financial frictions in rest of the world lead to net capital flows to US, fueling credit boom
- A crisis in US shifts financial intermediation to foreign banks, which puts stress in capital ratios abroad, spreading the crisis

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  - producers: borrowing constraints ⇒ lower demand for capital
  - financial frictions ⇒ higher savings, lower investment, and net capital outflows

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- Financial intermediaries
  - banks: capital requirement $\Rightarrow$ higher intermediation cost or interest-rate wedge

$$r_t^L - r_t^D = \rho\left(e_t\right) > 0$$

  - low bank capital $\Rightarrow$ lower savings, lower investment, and ambiguous effects on net capital outflows

$$S_t \text{ low and } I_t \text{ low} \;\Rightarrow\; S_t - I_t \lesseqgtr 0$$

  - low bank capital $\Rightarrow$ higher *gross* capital flows as intermediation shifts to foreign banks

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- With capital mobility crises are less severe but more frequent
  - shocks that lower foreign bank capital e_t^* and domestic bank capital e_t have similar effects

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- I would also analyze predictions on gross capital flows
  - shift of financial intermediation abroad suggests larger gross flows (?)
  - this might depend on whether crisis starts in country with initially stronger or weaker banks
  - evidence shows smaller gross flows

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  - frictions might also lead to lower bank deposits
    - riskier return on savings probably reduces savings
    - saving in real estate or durables instead of banks
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- Frictions on financial intermediaries
  - main contribution of the paper
  - theory: Allen, Gale (2000), Schinasi, Smith (2000), Goldstein, Pauzner (2001), Kyle, Xiong (2001), Kodres, Pritsker (2002), Yuan (2004)
  - empirics: Caramazza, Ricci, Salgado (2000), Kaminsky, Reinhart (2000), Hernandez, Valdes (2001), Van Rijckeghem, Weder (2001, 2003), Broner, Gelos, Reinhart (2006)

Comments on mechanism

- What is the nature of competition between banks?
  - if zero profits, how do they recover capital after crisis?
- Banks pay dividends because ex-ante probability of crisis is zero
  - is this robust to a small but positive probability of crisis?
- With default in equilibrium, crisis would affect foreign bank capital directly
  - stronger mechanism and more consistent with evidence on gross capital flows (?)
- Mark-to-market accounting
  - capital requirements play no useful role, so optimal policy is to eliminate them
  - need a model with a meaningful trade-off for evaluating mark-to-market