Comments on Financial Liberalization: Efficiency Gains and Black Holes by Ranciere and Tornell

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Overview

Theoretical analysis of long term tradeoff between financial repression with no financial crisis and financial liberalization with possible crises

1. main contribution is to clarify under which conditions financial liberalization can perform better than financial repression: growth extension of Scnheider and Tornell, 2004

2. If benefits of higher leverage and investment (growth) in no-crisis times compensate for bankruptcy costs + lower investment (growth) in crisis times weighted by frequency of crisis

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Three regulatory regimes

- ▶ Financial repression: firms cannot take insolvency risk
- ▶ Financial liberalization: firms in input sector (N) can take insolvency risks by issuing one period standard bonds denominated in units of final goods (T): currency mismatch
- ▶ "Anything goes": firms can issue (whithout collateral) catastrophe bonds paying zero in good states but huge amounts if crisis occurs

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Several market failures

- External effect in production technology (endogenous growth)
- Contracts are not enforceable: financing constraint in N sector, production efficiency lowered
- Sytemic bailouts: covers lenders against systemic crises not idiosyncratic default: induces N-firms to take insolvency risk by borrowing in bonds denominated in T-goods
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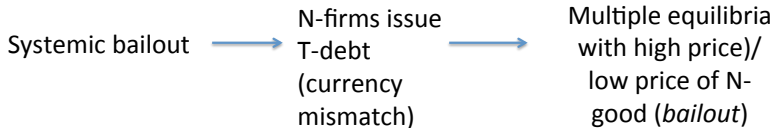- Bankrupcy costs in times of crisis

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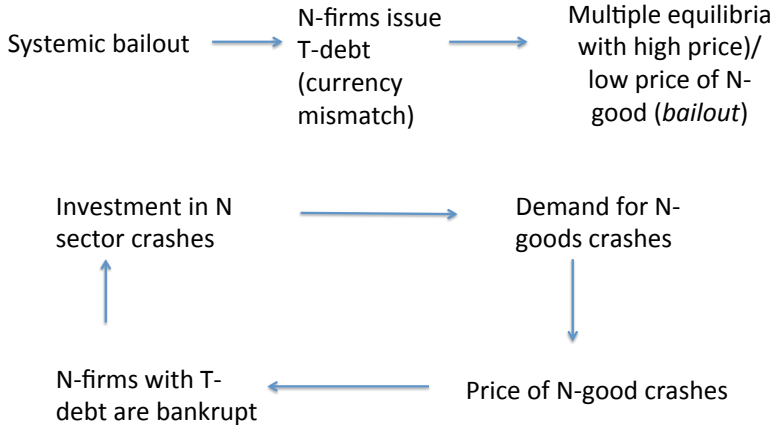- Bankrupcy costs in times of crisis

The risky regime: the possibility of a self-validating crisis

Systemic bailout → N-firms issue T-debt (currency mismatch) → Multiple equilibria with high price)/ low price of N-good (*bailout*)

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- Borrowing constraint = no diversion condition: $u(1+r)b + (1-u)x0 \leq h(w+b)$; u = proba of no crisis, expected reimbursment = cost of diversion

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- Borrowing and investment increase with higher probability of crisis (but u cannot be too low for equilibrium to exist): $b = \frac{hw\delta}{u - h\delta}$

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- ▶ The bailout is systemic and full by assumption and optimal by construction: taxes are lump sum and only bailout agency can recoup the portion μ of firms revenues

- ▶ If only partial bailout + convex cost for lender to increase lending, then leverage and investment (for some levels of u) would decrease with probability of crisis (1-u)

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- In a dynamic setting, make bailouts endogenous (distortive taxes)
- Interesting potential link between financial crisis and sovereign crisis and how interaction can affect long term growth: if full bailout impossible because of difficulty for states to borrow, borrowing constraint for firms increases

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- ▶ Close to historical average of crisis for both financially open and closed periods and countries : in model only open
- ▶ 2 to 4 times higher probability of financial crash in liberalized regime as in financially closed economies (Martin and Rey, 2008)

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