Discussion of:

Country Risk, Exchange Rates and Economic Fluctuations in Emerging Economies

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Main point of the paper

- Observed pattern of real interest rates:
  - Mildly Pro-cyclical in Advanced Economies
  - Counter-cyclical in Emerging Economies
- According to the authors this indicates the existence of market failure
- The paper digs into the determinants of this behavior

Methodology

- The model represents financing decisions in an environment in which:
  - Financial frictions create significant wealth effects
  - Borrowing is done in foreign (hard) currencies
- In this framework a currency depreciation leads, via wealth effects and stringent credit, to output and job losses (known)
- Paper focuses on the behavior of spreads
- Calibration for Chile and Australia

Very timely issue!

90s and Early 00s:

- Recurrent episodes of financial distress in EMEs, most with large impact on real economy. External borrowing, currency misalignments and balance sheet mismatches main culprits

- Recessions very mild and short in Advanced Economies

Very timely issue!

Now:

- The potential for the recession to lead to an erosion of credit ratings, and hence to doubts regarding fiscal sustainability, is a source of concern for both Advanced and EM Economies.

- According to WDI data, in 2007 real interest rates increased while growth slowed down in Iceland, Switzerland, Belgium, Italy and the US. Same happened in 2008 in Japan and New Zealand.

  - It seems that real rates in Advanced Economies also have the potential to turn countercyclical

Domestic versus international rates

A large number of EMs have turned to domestic debt markets in recent times:

- Monetary policy is absent but may be of prime importance:
  - ✓ Cyclical behavior of domestic real rates?
  - ✓ What is the goal of MP? Controlling inflation vs managing capital flows or exchange rates
- Is it too stringent to restrict borrowing to hard currencies?

Domestic versus international rates

- Mendoza and Yue (2008) deals with the same topic.
- They present a model of endogenous default risk within which EMs borrowing cost are countercyclical.
- They acknowledge that sovereign borrowing costs (EMBI) and domestic private borrowing costs may differ. However, using worldscope data, they find that both are negatively correlated with output growth...

Domestic versus international rates

Correlation real interest rate and GDP growth. 1980-2008

Belgium	-0.303	Denmark	0.050
Colombia	-0.241	Dominican Republic	0.593
Argentina	-0.765	Spain	0.028
Germany	-0.158	Peru	0.381
Chile	-0.428	Australia	0.188

Source: WDI and own calculations

Correlation real interest rate and GDP growth. 1990-2008

Belgium	-0.052	Denmark	-0.102
Colombia	-0.256	Dominican Republic	-0.292
Argentina	-0.765	Spain	-0.621
Germany	0.047	Peru	0.069
Chile	-0.049	Australia	-0.081

Source: WDI and own calculations

There is time-varying heterogeneity in the co-behavior of real rates and economic activity.

- **THE DEFINITION OF INTEREST RATE USED IS CRUCIAL…**

Market failure…policy reaction?

- We are in the presence of a market failure…what type of failure?
- Could it be understood as some form of credit rationing?
- Going forward…correction mechanisms?