

Discussion of Anton Korinek's

**“Regulating Capital Flows to Emerging Markets: An
Externality View”**

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Introduction

- Very nice paper. Makes some important points with a simple and elegant model.
- Conventional wisdom: free capital mobility may lead to excessive volatility of capital flows and crises. Some inflows are more dangerous than others:

FDI > portfolio flows or long-term debt flows > short-term debt flows

Domestic currency debt > foreign currency debt

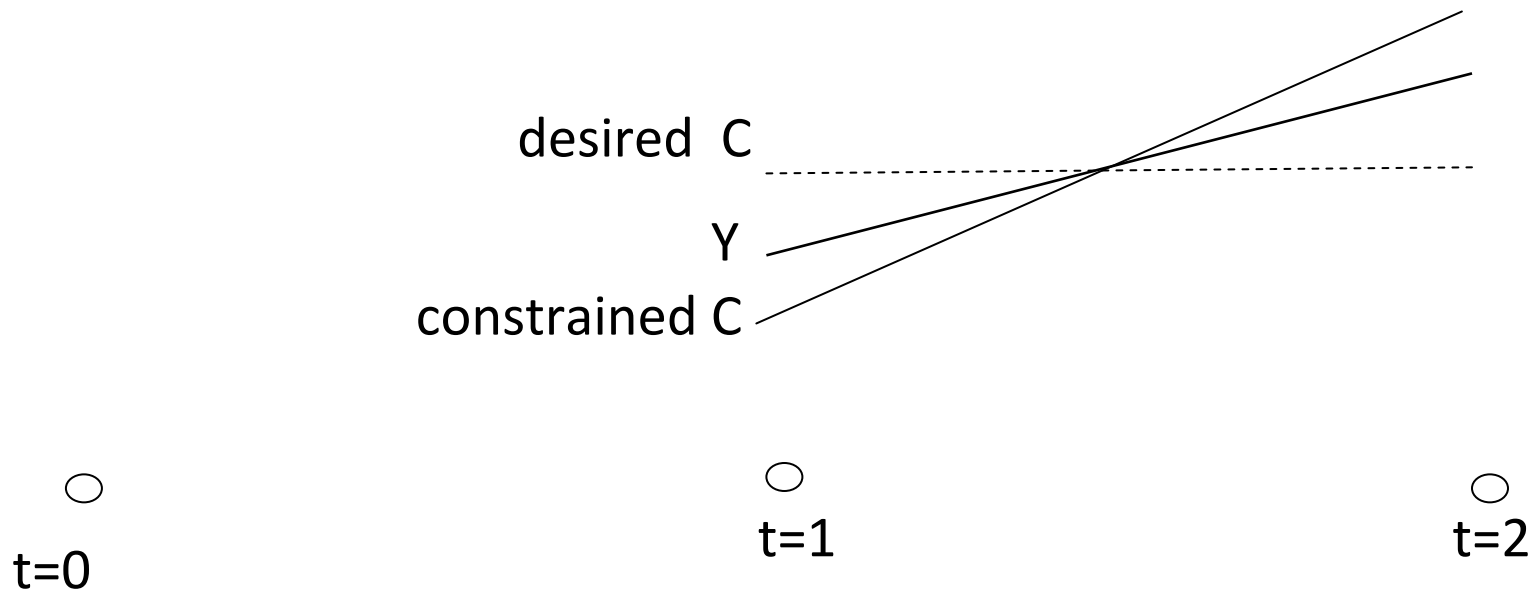
- But the distortions associated with capital flows not always theoretically clear (e.g., short-term debt can be reflection, not cause of problems).
- Here the case for public intervention is clear: an externality. A form of financial contagion involving the value of collateral.
- The paper characterizes optimal taxation on capital inflows (capital controls) and provides quantitative estimates.

Structure of my comments:

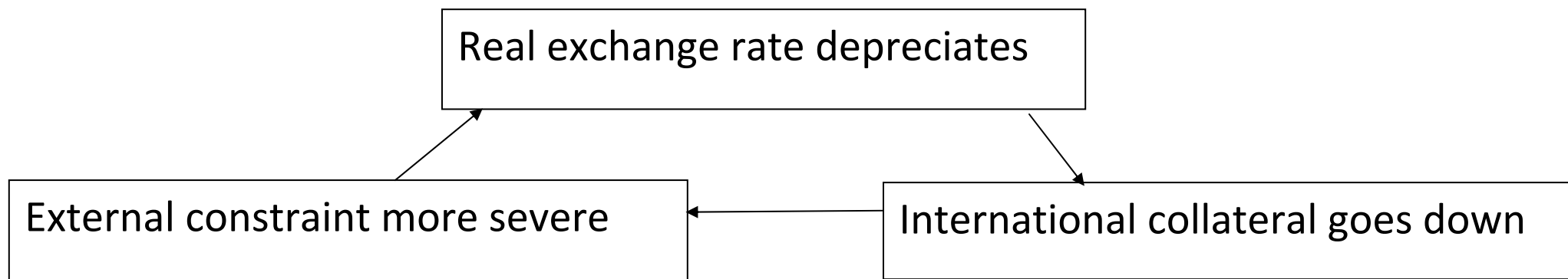
- Summary
- Two questions

I. Summary

- Open economy can be credit constrained following bad income shock



The constrained state involves a deleveraging loop



➔ Exchange rate overshooting.

- The loop is magnified if the country has more outstanding liabilities to repay in the constrained state.
- Individual consumers issue liabilities in $t=0$ to be repaid in $t=1$ (**complete markets**).
- Externality: each consumer does not internalize his contribution to the loop.
- ➔ if ROW is risk averse (insurance is costly), there is too little insurance under laissez-faire.
- Example; if choice between debt and equity, there will be too much debt relative to equity in aggregate (too much of both).

- Policy implication:
 - ➔ optimal to tax any liability that pays off in the constrained state;
 - ➔ tax more the type of liabilities that pay off more in the constrained state.
- Estimates of optimal tax based on Indonesia crisis: very nice (transparent, not black-box simulation; minimal assumptions).

Sample results (from Table 1).

Asset Class	Optimal tax
Short-term dollar debt	1.54%
Equity	0.31%

II. Two questions

1) Role of complete market assumption.

- The consumer is unconstrained in period 0 (i.e., can pledge any amount of future income through debt, equity, etc.)
- Simplifies the analysis, but not completely consistent with assumptions about period 1, and maybe not realistic (frictions, financial underdevelopment).
- It may matter for policy conclusions.

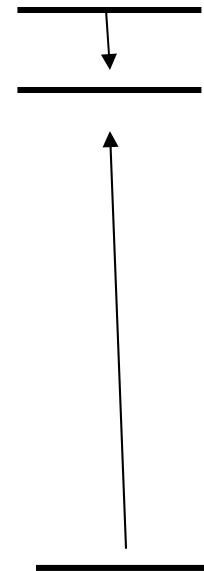
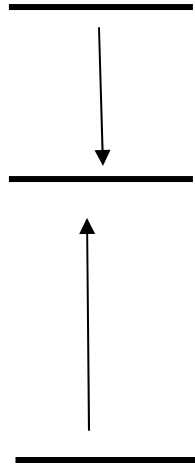
DEBT inflow

EQUITY inflow

Complete markets,
laissez-faire

Complete markets,
social planner

Incomplete markets,
laissez-faire



Which gaps should we worry about?

2) The optimal taxes are pretty low. Why?

Asset Class	Optimal tax
Short-term dollar debt	1.54%
Equity	0.31%

- The welfare loss of not smoothing consumption is relatively low in a model with $CRRA=2$.
 - Welfare cost of having $C_1=90$, $C_2=100$ rather than $C_1=C_2=95$?
0.6% of ex ante consumption
 - If probability of crisis is 5%: the consumer is ready to pay 0.03% of his consumption ex ante to insure against credit constraint.
- The welfare cost of dangerous liabilities could be higher, through channels that are not in the model (endogenous probability and size of output loss)

Conclusions

- Paper's bottomline: the debt-deflation externality justifies (a very mild level of) public intervention to restrain capital inflows.
- It would be interesting to explore robustness to: incomplete markets; different preferences; channels where liability structure affects probability and output cost of crisis.