

Federal Reserve Bank of Dallas Conference

"Financial Frictions and Monetary Policy in an Open Economy"

Discussion of Devereux, Senay and Sutherland's

"Nominal Stability and Financial Globalization"

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The Paper

- ▶ Very interesting and elegant paper
- ▶ Contributes to the literature on the determinants of international capital flows
- ▶ Argues that the expansion of countries' gross external positions is the result of a more aggressive monetary policy that lowered inflation variability

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- ▶ Develops this idea in the context of an open-economy model with endogenous portfolio choice
- ▶ Provides some supporting evidence

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- ▶ Optimal hedging against relative income shocks implies that $\tilde{\alpha}_i$ must be larger (in absolute value) the larger the correlation between ζ_y and r^i , and/or the smaller the variability of r^i relative to that of ζ_y

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- ▶ These are robust predictions (across specifications and parameter values)

COMMENTS

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 - ▶ Omitted variables
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 - ▶ Endogeneity (or simultaneity) of $\sigma(\pi)$
- ▶ I am going to argue that, despite these potential sources of bias, the evidence presented by DSS is fairly robust

Robustness: Adding more Variables

	Dep. variable: Total portfolio (% of GDP)			
	(1)	(2)	(3)	(4)
Standard dev. of inflation	-5.12*** (1.17)	-4.17*** (1.15)	-4.63*** (4.02)	1.6 (1.00)
Gvt spend. (% of GDP)	—	-0.32 (0.33)	—	—
Long-term real int. rate	—	—	-0.33*** (3.73)	—
Real effective exch. rate	—	—	—	-0.48 (0.48)

Robustness: Adding more Variables

- ▶ Only when the real effective exchange rate is included in the regression, does the coefficient on inflation volatility become insignificant
- ▶ But the real exchange rate is also an endogenous variable, so there's no reason why one should have more confidence in these results than in those of the baseline regression

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 - ▶ Volatility of sales taxes (as % of GDP)

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Standard dev. of inflation	-87.64 (0.45)

Robustness: Dealing with Endogeneity

- ▶ Although the coefficient on inflation volatility is no longer significant at the 5 or 10 percent levels, the point estimate is always large and negative
- ▶ Bottom line: inflation volatility has some (negative) effect on financial integration

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- ▶ Why not test the model's prediction directly?

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- ▶ This approach is likely to be less plagued by endogeneity issues

Testing the Model's Predictions

- ▶ One could also test for the presence of the correlation and variability effects by checking whether gross portfolio positions vary monotonically with $\text{corr}(\zeta_y, r^i | r^j)$ and $\frac{\text{std}(\zeta_y | r^j)}{\text{std}(r^i | r^j)}$

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- ▶ Another testable prediction of the model is that equity home bias increases with inflation volatility. This should be easy to check in the data

Some Final Questions

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- ▶ The paper's main point is that lower inflation volatility in one country leads to an expansion of gross portfolio positions, but the data clearly show that inflation volatility has decreased in almost all countries. If lower inflation volatility is a global phenomenon, should we still expect to see a larger degree of financial globalization?

Conclusion

- ▶ DSS convincingly show that, in theory, more aggressive monetary policy can lead to greater financial integration
- ▶ They provide some suggestive evidence that supports this view
- ▶ In my opinion, a stronger case can be made by taking some of the model's (sharp) predictions directly to the data