Leaning against the Global Financial Cycle

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BdF-IMF-OECD Conference
October 26, 2021

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Insightful paper

• Institutions matter in shaping the counter-cyclical policy response to the global financial cycle and the impact of global financial shocks on the domestic economy

• Corroborating other evidence on the importance of institutional quality in international finance
  • Industries that are dependent on good institutions grow faster as foreign capital flows in (Igan, Lauwers, Puy 2021)
  • Stronger institutions mitigate the adverse impact of social unrest on stock markets (Bondar et al 2021)
Basic framework

- Global shock $S_t$ affecting economic activity (GDP) / financial conditions (equity returns, sovereign spread, FX)
  - Excess bond premium (alternatively, VIX)

- $Z_{t-1}$ institutional features over which the government has some control and that can shield the economy from $S_t$
  - **Rule of law**, Government effectiveness, Control of corruption, Regulatory quality, Political stability and absence of violence

- Policies (MP, MaPP, CFM, RM) that respond to $S_t$
  - Short-term interest rate, iMaPP loosening/tightening indicator, Capital controls, Change in level of reserves scaled by nominal GDP

- $X_{t-1}$ country-specific fundamentals and other features that are more difficult to control and/or affect the transmission of $S_t$
  - **K-account openness** and **FX regime**
  - Current account balance, US$ debt, NFA
What are institutions?

• Where to draw the line between institutional features and “other” features?
  • CFM policy variable but capital account openness and FX regime are “other features”? Choice because of the trilemma?

• Comparison to the IPF:
  • Conditions such as FX denomination of debt matter but isn’t this correlated with institutional quality?
  • Is institutional quality a proxy of what others have called vulnerabilities? Highly correlated obviously but important to understand what exactly is the mechanism (which is easier to do with “vulnerabilities” variables)

• Policy takeaway:
  • If a country can use (monetary and FX) policies effectively, why bother with anything else? How to bring in more empirical support?
Disconnect between the empirical and conceptual parts

- Flexible prices, no explicit modelling of FX, as the authors recognize
  - FX movement an implicit mechanism affecting borrowing constraints
- Policies loosely corresponding to those in the empirical part
  - Distinction between MP/FXI and MaPP/CFM lost
- Structural reforms do not have a direct bearing on the effectiveness of countercyclical policies
  - Choice is simplified to picking the less costly option between ex ante and ex post stabilization
Further checks on empirics

• Institutional quality data: Why not also look at Voice and accountability? Alternative source ICRG?

• Sample selection:
  • Enough variation in institutional quality over time to identify the impact over and above country fixed effects?
  • EM vs AE (ongoing work at the IMF suggests different interactions of countercyclical policies in country groups)?

• Fiscal stance/credibility missing factor?

• Stock returns the only (private) financial variable, missing important part in bank-based systems?

• MP measure ST i-rate, is it possible that in some countries this does not capture MP stance well?

• New FXI database, beyond change in the level of reserves: check Adler et al 2021
Summing up

• A message many of us would be inclined to agree with: institutions do matter

• Suggestion to sharpen by:
  • Exploring the exact channel
  • Bringing the conceptual model closer to the empirics
  • Conducting further robustness checks
Thank You