Discussion of BCORY’s
“Optimal Policy with Occasionally Binding Credit Constraints”

by Anton Korinek
University of Maryland

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Central Question

Emerging market economies frequently experience “sudden stops”

What is the optimal policy response?
- ex-ante
- ex-post

Very important question
Outline

- Summary

- Three main questions:
  - Ex-ante vs. ex-post policies
  - Practical implementation
  - Specification of constraint
Basic Setup

- model of small open emerging market economy
- occasionally binding credit constraints
- *financial amplification* when constraints bind
- government has one policy instrument: subsidy to stabilize exchange rate
Feedback Loop

\[ b \leq \varphi (Y_T + p_N Y_N) \]

Tightening Constraint

Plummeting Exchange Rate

Falling Spending

Negative shock
Feedback Loop

\[ b \leq \varphi (Y_T + p_N Y_N) \]
Feedback Loop

\[ b \leq \varphi (Y_T + p_N Y_N) \]
Main Result

Optimal policy in the paper:
- no intervention when constraint loose
- intervention when constraint binding:
  - subsidize non-tradable sector to stabilize real exchange rate (standard second-best argument)
  - financed through lump-sum tax
Pecuniary Externality

\[ b \leq \varphi \left( Y_T + p_N Y_N \right) \]

- **Negative shock**
  - Efficiency: agents do not internalize their effects on exchange rates
Inefficiency

Generic inefficiency in economies with financial amplification effects:

- small agents do not internalize that their actions have price effects
- prices in turn affect constraints

→ classic pecuniary externality argument
Contribution More Generally

Relevance for current global financial crisis:

- financial amplification effects *always* entail a pecuniary externality

- authors’ findings apply to a much wider range of questions
Ex-Ante vs. Ex-Post Action

Three margins that a planner could affect:
1) ex-post (when constraint is binding):
   tradable/non-tradable consumption choice
2) ex-post: labor/consumption choice
3) ex-ante (before constraint binds): Euler equation

- paper admits only instrument 1

→ incomplete set of tax instruments
→ no scope for ex-ante action can be found if planner has no ex-ante instrument!
Ex-Ante vs. Ex-Post Action

Further point:

- combination of instrument 1) and 2) can be used to set $p_N$ to arbitrary level and restore first-best equilibrium (subsidize N consumption and tax N production by identical amount)
Ex-Ante Policies

Optimal ex-ante policy actions:

- tax excessive or risky borrowing so that agent avoids binding constraints = Pigovian tax
- constrained social optimum restored

→ first line of defense

Still: ex-post actions are extremely important
Practical Implementation

in model: stabilize exchange rate
  (transfers would not work)

in practice: how do we best accomplish this?
  - many countries that try it run out of reserves
    (no lump-sum taxation…)
  - others incur huge costs and create global
    imbalances

→ analysis of optimal reserve policy under
  *distortionary taxation* would be interesting
in paper: credit limit depends on current income

\[ b(t) \leq \varphi [Y_T(t) + p_N(t)Y_N(t)] \]
Specification of Credit Constraint

- in paper: credit limit depends on current income
- alternative approach: limit depends on pledgeable future income $\rightarrow$ role for investment

\[ b(t) \leq \phi[Y_T(t) + p_N(t)Y_N(t)] \]

\[ b(t) \leq \phi[Y_T(t+1) + p_{N(t+1)}Y_N(t+1)] \]
Specification of Credit Constraint

- in paper: credit limit depends on current income
- alternative approach: limit depends on pledgeable future income → role for investment

- other important channels in sudden stop dynamics:
  - nominal exchange rate depreciation
  - declines in asset prices
    interact with borrowing constraints

→ same policy conclusions carry through in all these specifications
→ quantitative effects in reality probably even larger
Conclusions

- Excellent paper on optimal ex-post policies during sudden stops

- But delineate contribution more carefully: there is also a strong case for ex-ante policies (Korinek 2008, 2009; Bianchi, 2009; Korinek and Jeanne, 2009)

- More details on practical implementation of ex-post policies (esp. taxation) desirable