



Discussion of BCORY's

“Optimal Policy with Occasionally Binding Credit Constraints”

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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

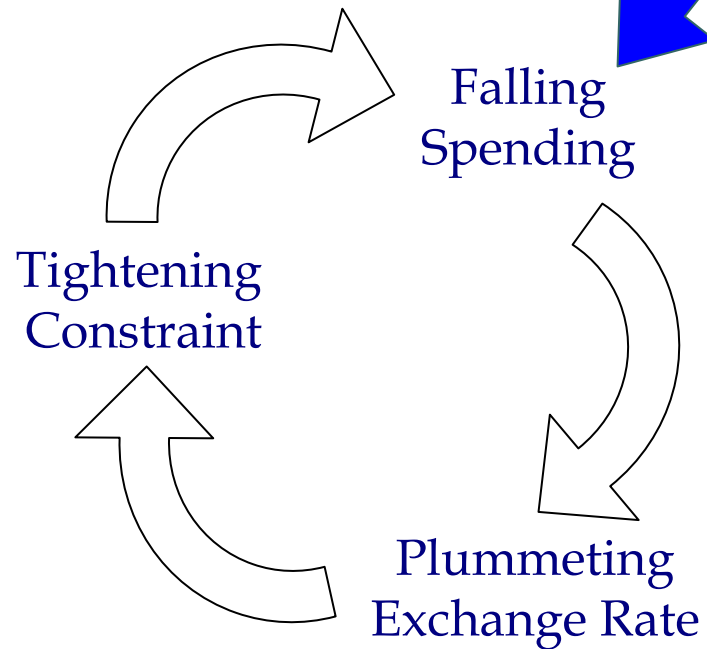
- model of small open emerging market economy
- occasionally binding credit constraints
- *financial amplification* when constraints bind
- government has one policy instrument: subsidy to stabilize exchange rate



# Feedback Loop

$$b \leq \varphi (Y_T + p_N Y_N)$$

Negative shock



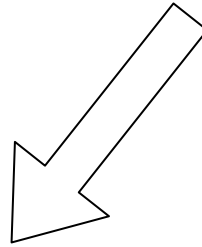


# Feedback Loop

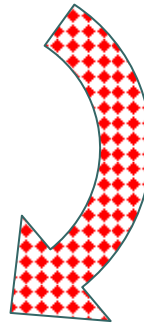
$$b \leq \varphi (Y_T + p_N Y_N)$$



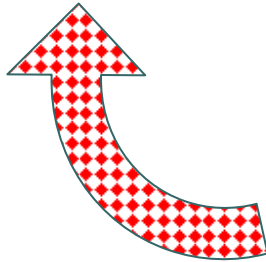
Negative shock



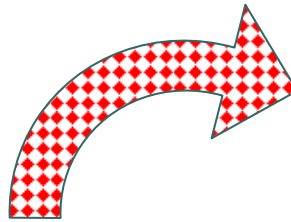
Falling  
Spending



Plummeting  
Exchange Rate



Tightening  
Constraint

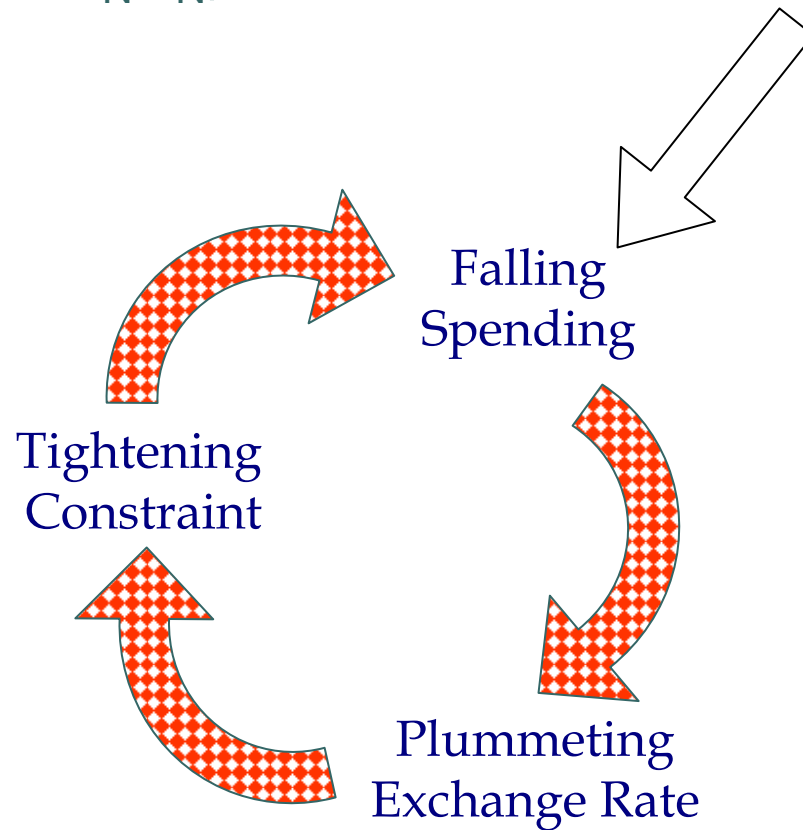




# Feedback Loop

↓  
 $b \leq \varphi (Y_T + p_N Y_N)$

Negative shock





# 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

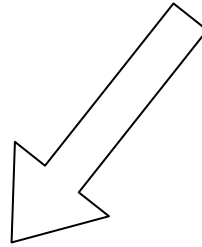




# Pecuniary Externality

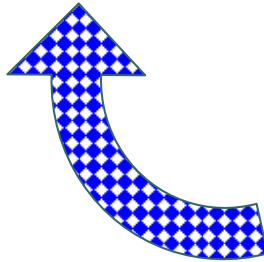
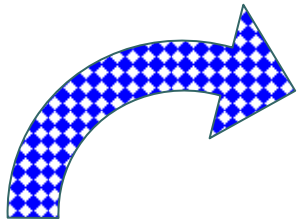
$$\downarrow b \leq \varphi (Y_T + \downarrow p_N Y_N)$$

Negative shock

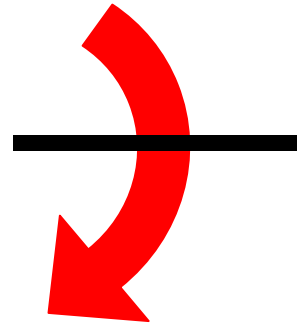


Falling Spending

Tightening Constraint



Plummeting Exchange Rate



**inefficiency:**  
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?

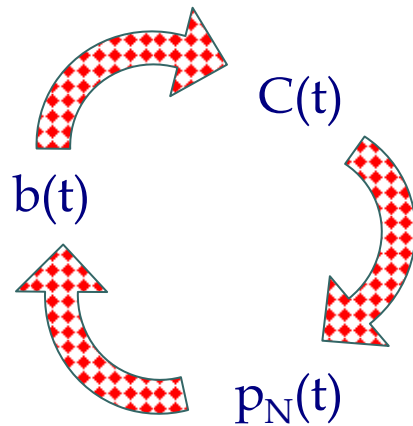
- many countries that try it run out of reserves (no lump-sum taxation...)
- others incur huge costs and create global imbalances

→ analysis of optimal reserve policy under *distortionary taxation* would be interesting



# Specification of Credit Constraint

- in paper: credit limit depends on current income



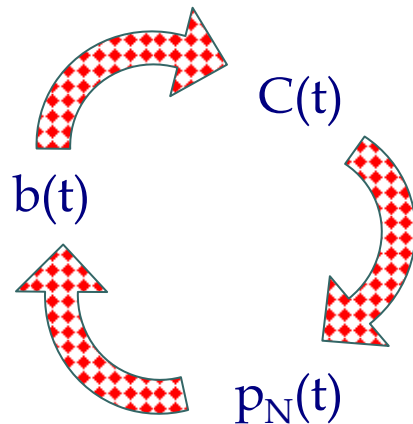
$$b(t) \leq \phi[Y_T(t) + p_N(t)Y_N(t)]$$



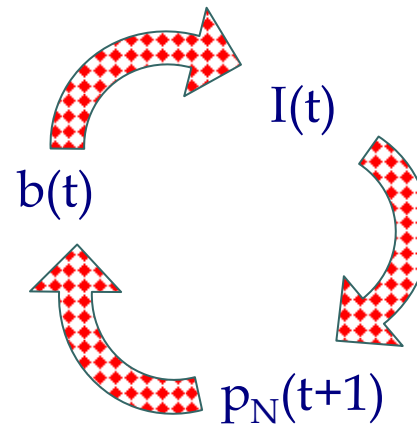


# Specification of Credit Constraint

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



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



$$b(t) \leq \varphi[Y_T(t+1) + p_N(t+1)Y_N(t+1)]$$



# 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 pricesinteract 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