

# Monetary Policy under Sudden Stops by Vasco Cúrdia

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Discussion  
by

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*The views expressed in this discussion do not necessarily represent the views of the ECB*

# Introduction

- Very nice paper
- gives very informative account of stylized facts
- offers a very comprehensive review of the related literature
- and is very well drafted

# Objective of the paper

- This paper tries to answer the question:

Which policy rule is best in mitigating the consequences of a sudden stop?

- The main conclusion is

Fixed exchange rates are bad

- Related literature on the same question: Céspedes, Chang and Velasco (AER 2004) and Devereux, Lane and Xu (EJ 2006)

- They use very similar models and get very similar answer:

Fixed exchange rates are bad

# Main Contribution

- This paper offers an alternative explanation of the source of the sudden stop
- Instead of aggregate structural shocks, Vasco introduces shocks to the risk premium.

# Commented summary of the model

- Consumers have no direct access to international financial markets. Yet they own domestic firms.
- At face value this assumption is not particularly reasonable
- It is not irrelevant though: wealth effect on demand through reduced dividends
- Alternatives:
  - Céspedes et al.: Consumers have only labour income
  - What if households can trade in bonds with an intermediary who has access to foreign capital: banks? government?
- Would the results differ?

## Summary cont'd

- Intermediate-goods producers need **imported inputs** for production: they must raise funds abroad to finance the purchase of these inputs. This is the BGG **financial accelerator** (FA) assumption.
- Crucial departure from standard FA: **lenders observe the borrower's productivity only with some noise.**
- **The misperception is the trigger of the sudden stop.**

This is not a bad assumption at all. The only problem is that (at this stage) it is totally exogenous. It is independent of how the economy is doing and policy cannot do anything about it.

$$(1) \quad \text{Risk Premium} = \chi \left( -\frac{N_t(j)}{S_t P_{Z,t}^* Z_t}; \kappa_t \right)$$

- E.g. [Céspedes et al.](#) have a standard FA model (without the  $\kappa$ ) and consider the effect of aggregate shocks (world interest rate) on the risk premium:
  - a devaluation implies that net worth falls relative to the value of investment: [this is essentially an intermediate input partially imported](#). The risk premium increases squeezing the domestic economy.
- [The misperception shock is potentially more powerful](#). Yet the mechanism is very similar.
- Hence, all boils down to: [What is the trigger of the contraction in the real world?](#)

## Summary cont'd

- Vasco claims that “By linking the shock to the foreign interest rate [Céspedes et al. etc.] implicitly assume that the shock influences all emerging countries at the same time and rule out country-specific sudden stops”.
- This is not a logical implication of external shocks: just need asymmetries in structures, policies, indebtedness etc.
- One could ask: why lenders receive the (non-fundamental) signal  $\kappa$  for one country and not for another country?



# The likelihood of a sudden stop

- An important not-addressed question is: *is there a monetary policy that reduces the likelihood of a sudden stop?*
- E.g. Caballero and Krishnamurthy (NBER,2004) monetary policy affects the amount of precautionary saving in the economy.
- *Can we think of something similar in this model?*  
(e.g. second order effects of uncertainty: even if the sudden stop is exogenous a bad policy will increase volatility, if a larger net-worth can reduce it, would there not be the incentive to to save more?).
- What is optimal “given” the sudden stop could be sub-optimal in a world of endogenous sudden stops (à la Mendoza)

# Calibration

- Besides the shock, other major difference w.r. to related literature is the parametrization.
- This should appear right at the beginning as one of the motivations of the paper: e.g. “this paper takes Céspedes et al. + different calibration and risk-premium and gets...”

## Calibration cont'd

- In particular the **key parameters of the model** seem to be the elasticity of foreign demand and elasticity of domestic demand for imports.
- E.g. The baseline case in the model has an elasticity of foreign demand of 0.6. It looks small in general: it might apply to particular countries (e.g. oil-exporters).
- The elasticity of demand for imported inputs is set to 1 in the baseline case. Braggion et al. argue for a Leontieff aggregator.
- **Would there still be a sudden stop?**

# Comparison of Taylor rules

- The analysis of the extreme cases (à la Devereux et al.) is informative (fixed exchange rate, constant inflation etc.)
- The analysis of intermediate cases is less informative. At most I would look at the standard Taylor rule (there is already a lot of stuff).
- Vasco emphasizes that “... it is more important to influence agents’ expectations about future monetary policy”.

This is in general a very important point. Yet it is not really shown in this paper. Here all policies are announced in a credible way. *We are not told, in this paper, what would happen otherwise.*

## Some minor points

- **GDP vs. aggregate demand**: in the IR you show aggregate demand yet GDP would differ in a possibly important way!

(2) 
$$\text{GDP at constant prices} = Y_t - \text{tot}_0 Z_{t-1}$$

On impact the relative change of GDP is smaller than aggregate demand. More importantly, from period  $t + 1$  onwards  $Z$  will fall considerably: a further reason for GDP to fall less than aggregate demand. Here the elasticity of demand for imports is crucial

- Large shocks and **linearization**. Very few seem to care about this. But is it a problem when we study large shocks?
- Large shocks and “deepness” of the **structural parameters**: Are we sure that firms and household would do “business as usual”?

# Conclusion

- This is a very nice paper: brings up an alternative view on sudden stops
- The challenge now is to find convincing empirical support for the “misperception” channel.
- The paper could be shortened focusing more on the differences with respect to existing results
- Follow-up papers should look at the role of policy ex ante and
- provide theoretical foundations for the misperception story (learning?)