Interest Rate Uncertainty as a Policy Tool

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*The views expressed are those of the author and do not necessarily represent official positions of the Central Bank of Argentina or its Board members.*
What are the macro effects of widening the O/N rate corridor?
This paper:

- **Wider Corridor** → **Higher Interest Rate Uncertainty** → **Macro Effects of IR Uncertainty**

Main channels:
- Precautionary savings.
- Precautionary inflation.
- FDI effect (new).
Review of the Paper

This paper:

- Wider Corridor
- Higher Interest Rate Uncertainty
- Macro Effects of IR Uncertainty

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My comments: Insightful first approach to the question.
- The effects of domestic interest rate volatility.
- It’s use as a policy tool.
The effects of domestic IR Volatility

- Contribution to the expanding literature on the effect of volatility shocks.
- From a SOE perspective, the FDI effect is novel and potentially relevant.
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- From a SOE perspective, the FDI effect is novel and potentially relevant.
- The volatility process:
  - Model time period?
  - Justifying the calibration.
  - Size of the volatility shock (2 sd) and calibrated persistence: What is the mapping with the policy implemented in Turkey?
  - Non-linearities and different shock sizes.
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- FDI and investment:
  - Lack of inv. adj. costs may overemphasize this channel.
  - Time-to-build in both types of investment.
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  - Lack of inv. adj. costs may overemphasize this channel.
  - Time-to-build in both types of investment.
- Role of countercyclical markups.
  - Basu and Bundick (EMA, 2017), Seoane (IER, 2017).
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What is the problem to be solved?
- Policy discussions: “excessive” capital flows.
- Does the model generate inefficient capital flows?
- Pecuniary externality / over-borrowing? e.g. Bianchi (AER, 2011).
- Sticky prices and aggregate demand externality? Fahri and Werning (EMA, 2016).
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Welfare analysis I:
- How does welfare change in the presence of this shocks?
- Traditional reasoning without inefficiencies: more volatility ⇒ less welfare.
- With rigidities/frictions it depends on the model.
Welfare analysis II:

- The policy design exercise may require a model where the interbank market is explicitly included.
- In such a framework, policy rate ≠ market rate.
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Why is FDI a relevant part of the problem to be solved?

- Many times politicians argue that “speculative capital inflows” crowd-out FDI, and use it as an argument to implement policies.
- The paper shows that more IR volatility may not help in this front.
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IR Volatility as a policy tool

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▶ Is the problem to be solved generated by inconsistencies in the policy framework?
▶ Some related examples:
  ▶ Argentina 2018.
  ▶ Uruguay 2013.
A way of thinking about this policy in a DSGE model.

Let $R_t$ be the policy rate and $M_t$ the quantity in the market where policy operates (e.g. the amount traded in the interbank market).

Let $R^T_t|_{t-1}$ be the desired rate (e.g. Taylor rule), and $M^T_t|_{t-1}$ the quantity consistent with $R^T_t|_{t-1}$.

Ex-post these might differ due to shocks.

Alternative regimes:

- IT: $R_t = R^T_t|_{t-1}$, and $M_t$ might differ from $M^T_t|_{t-1}$.
- Quantity target: $M_t = M^T_t|_{t-1}$, and $R_t$ might differ from $R^T_t|_{t-1}$.
- Hybrid regime: Use the rule
  \[
  \lambda(R_t - R^T_t|_{t-1}) = (1 - \lambda)(M_t - M^T_t|_{t-1}),
  \]
  \(\lambda \in [0, 1]\).
  Widening the corridor is analogous to decreasing $\lambda$.

This is related to the work by Berg et al. (IMF, 2010).
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- A way of thinking about this policy in a DSGE model.
- Let $R_t$ be the policy rate and $M_t$ the quantity in the market where policy operates (e.g. the amount traded in the interbank market).
- Let $R_{t|t-1}^T$ be the desired rate (e.g. Taylor rule), and $M_{t|t-1}^T$ the quantity consistent with $R_{t|t-1}^T$.
- Ex-post these might differ due to shocks.
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    \[ \lambda(R_t - R_{t|t-1}^T) = (1 - \lambda)(M_t - M_{t|t-1}^T), \quad \lambda \in [0, 1] \]
  - Widening the corridor is analogous to decreasing $\lambda$.
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