Financial Frictions, Foreign Currency Borrowing, and Systemic Risk

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Discussion by

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Channels for systemic risk and contagion

- Presentation at the Turkish Central Bank
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• Presentation at the Turkish Central Bank

• Interbank exposures
Channels for systemic risk and contagion

- Presentation at the Turkish Central Bank

- Interbank exposures
  - Effects end after one round!
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- Information contagion
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• Fire-sale externalities
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• Information contagion

• Fire-sale externalities

• Currency mismatch and currency risk
  – Current account deficit
Summary

• The paper is in the spirit of twin crises.

• Firms can borrow in domestic currency (TL) or in foreign currency ($).

• Revenue is in TL.

• There is a risk of devaluation.

• Firm succeeds only when the return (in TL) is high and there is no devaluation.

• Exposes firms that borrow in $ to currency risk.
Summary

• High effort increases the probability of success.

• Limited liability and unobservability of effort.

• Interest rate on borrowing in $ is lower.

• Borrowing in $ improves firms’ incentives.

• Hence, improves idiosyncratic risk.
Summary

- Borrowing in $ improves idiosyncratic risk.
- BUT exposes the economy to currency risk
- Hence, increases system-wide risk.
- Effects are more pronounced when contagion through widespread bankruptcies.
Comments

- Incentives: How do we take this to empirics?
- Causality:
  - Borrowing in $ improves incentives.
  - Firms that can borrow in $ are well run firms.
Comments

• Turkey (2000, 2001)

• Deficit financed through borrowing at high interest rate.

• Exchange rate used as a nominal anchor to curb inflation (stable around 80%). Over valued domestic currency, current account deficit …

• Banks enjoy carry trade: Borrow in $, lend in TL.

• Good business while it lasts!
Overall

• Nice paper.

• Clean and simple model with interesting results.

• A very important issue.

• Current situation in Europe (European banks financing $ assets).