Comments on Tornell's Paper

Kyoji Fukao

Although the major part of this paper is based on a theoretical model, which was originally presented in Schneider and Tornell's NBER Working Paper, the author does not provide substantial explanation of the model in this paper. I found that without reading Schneider and Tornell's paper, it is very difficult to understand this paper. I would like to ask the author to add sufficient explanation of the background model to this paper.

Let me explain Schneider and Tornell's model, first. The model is based on two basic assumptions.

First, there are bailout guarantees for systemic risk in the non-tradable goods sector (N-sector). The guarantees make firms choose risky investment plans. The guarantees also work as a kind of investment subsidy.

Second, because of contract-enforceability problems, firms face borrowing constraints. The size of firms' investment is constrained by the amount of their internal funds.

In financial theory, we know these two mechanisms very well. But by combining these two mechanisms and by including several additional assumptions, Schneider and Tornell have constructed a very interesting general equilibrium model.

The additional assumptions are that firms borrow foreign currency in order to make their investment plan risky; and that the real exchange rate is determined by the equilibrium condition in the non-tradable goods market. Multiple equilibria exist in the model. If the domestic currency depreciates, firms in the non-tradable goods sector go bankrupt and investment demand for non-tradable goods declines. In this way a self-fulfilling currency crisis occurs. When there is no crisis, the N-sector will gradually grow. This is the essential part of Schneider and Tornell's model.

In this new paper, the author takes the following strategy. He assumed that Schneider and Tornell's model is completely correct and derived several policy implications from it. His main policy implication is "The introduction of systemic bailout guarantees can increase the credit and investment multiplier," and "can be considered second-best-optimal."

I think that the author's strategy is not very successful. When we construct a model, we can use bold assumptions in order to simplify the model. Schneider and

Tornell's paper is excellent. But when we write a paper on economic policy, we need to be more careful about the underlying assumptions. I wished the author would consider the applicability of the model to actual economies, providing more evidence.

Let me provide a few examples.

First, it is assumed that international borrowing is used as a device to create systemic risk by small-sized N-sector firms. But it is not clear why firms do not use other macro variables to create systemic risk. For example, in many countries, including Japan, investments in real estate created systemic risk.

Second, even if the probability of a currency crisis occurring is low, it is too costly for developing economies to intentionally create risk of currency crisis. There are many other better policy to enhance the growth of the N-sector. The first-best policy would be to reduce enforcement problems through raising penalties on diversions. The government can use tax incentives to promote investment in N-sector, tax T-sector, or subsidize borrowing by N-sector firms. I would like to ask the author to show why no other policy options are available.