Discussions of Devereux, Senay, and Sutherland’s
"Nominal Stability and Financial Globalization"

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The Paper

- Very interesting and elegant paper
- Contributes to the literature on the determinants of international capital flows
- Argues that the expansion of countries’ gross external positions is the result of a more aggressive monetary policy that lowered inflation variability
Contribution of the Paper

- Previous literature has rationalized the negative correlation between financial globalization and lower inflation volatility in terms of a causal link running from the former to the latter.
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- Several arguments have been invoked:
  - Openness increases competitiveness, steepens the inflation-output trade-off, imposes more "discipline" on domestic monetary policy, etc.

DSS' s paper suggests that the causality may be running in the opposite direction: lower inflation volatility leads to increasing financial integration.

Develops this idea in the context of an open-economy model with endogenous portfolio choice.

Provides some supporting evidence.
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- The equilibrium gross portfolio position in asset $i$ is given by

$$\tilde{\alpha}_i = -\frac{1}{2} \text{corr}(\zeta_y, r^i | r^j) \frac{\text{std}(\zeta_y | r^j)}{\text{std}(r^i | r^j)},$$

where $r^i$ is the relative return on asset $i$ and $\zeta_y$ is the innovation in the present value of relative income.
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where $r^i$ is the relative return on asset $i$ and $\zeta_y$ is the innovation in the present value of relative income.

- Optimal hedging against relative income shocks implies that $\tilde{\alpha}_i$ must be larger (in absolute value) the larger the correlation between $\zeta_y$ and $r^i$, and/or the smaller the variability of $r^i$ relative to that of $\zeta_y$. 

More aggressive monetary policy lowers $\text{std}(r_i|\epsilon^j)$ relative to $\text{std}(\zeta_y|\epsilon^j)$: variability effect
Intuition (Con’t)

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- When markets are incomplete, it also increases $corr(\zeta_y, r^i|r^j)$ (in absolute value): correlation effect
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These are robust predictions (across specifications and parameter values)
COMMENTS
A Not-So-Original Comment about the Empirical Part

DSS run the following regression:

\[ \frac{GP}{GDP} = \beta_0 + \beta_1 \sigma(\pi) + \beta_3 \text{Open} + \epsilon_t \]

There are at least 2 potential sources of bias in this regression (this is clearly acknowledged by DSS):

- Omitted variables
- Endogeneity (or simultaneity) of \( \sigma(\pi) \)

I am going to argue that, despite these potential sources of bias, the evidence presented by DSS is fairly robust.
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### Robustness: Adding more Variables

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<tr>
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<th>Dep. variable: Total portfolio (% of GDP)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Standard dev. of inflation</td>
<td>$-5.12^{***}$</td>
</tr>
<tr>
<td></td>
<td>(1.17)</td>
</tr>
<tr>
<td>Gvt spend. (% of GDP)</td>
<td>$-0.32$</td>
</tr>
<tr>
<td></td>
<td>(0.33)</td>
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<tr>
<td>Long-term real int. rate</td>
<td>$-0.33^{***}$</td>
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<tr>
<td>Real effective exch. rate</td>
<td>$-0.48$</td>
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Robustness: Adding more Variables

- Only when the real effective exchange rate is included in the regression, does the coefficient on inflation volatility become insigniﬁcant.

- But the real exchange rate is also an endogenous variable, so there’s no reason why one should have more conﬁdence in these results than in those of the baseline regression.
If inflation volatility is determined jointly with the gross portfolio position, then one needs to instrument for it. Finding a good instrument is not an easy task. A good instrument should affect the gross portfolio position only through its effect on inflation variability. I am going to stick my neck out and propose 2 candidates:

1. Volatility of the growth rate of M1
2. Volatility of sales taxes (as % of GDP)
Robustness: Dealing with Endogeneity

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<td></td>
<td>−87.64</td>
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Robustness: Dealing with Endogeneity

- Although the coefficient on inflation volatility is no longer significant at the 5 or 10 percent levels, the point estimate is always large and negative.

- Bottom line: inflation volatility has some (negative) effect on financial integration.
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- This approach is likely to be less plagued by endogeneity issues.
Testing the Model’s Predictions

- One could also test for the presence of the correlation and variability effects by checking whether gross portfolio positions vary monotonically with $\text{corr}(\zeta_y, r^i | r^j)$ and $\frac{\text{std}(\zeta_y | r^j)}{\text{std}(r^i | r^j)}$. Another testable prediction of the model is that equity home bias increases with inflation volatility. This should be easy to check in the data.
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Some Final Questions

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- The paper’s main point is that lower inflation volatility in one country leads to an expansion of gross portfolio positions, but the data clearly show that inflation volatility has decreased in almost all countries. If lower inflation volatility is a global phenomenon, should we still expect to see a larger degree of financial globalization?
Conclusion

- DSS convincingly show that, in theory, more aggressive monetary policy can lead to greater financial integration.

- They provide some suggestive evidence that supports this view.

- In my opinion, a stronger case can be made by taking some of the model’s (sharp) predictions directly to the data.