Comments on "From chronic inflation to chronic deflation"
by
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Overview

• The paper covers an array of big macro-financial themes
  – Expectations, the value of money, emerging-market inflation, liquidity crises, deflation...
  – Reflecting Guillermo’s key contributions in many of these areas – and partly based on a forthcoming volume collecting a number of them
  – Deep insights drawn from a variety of highly stylized settings

• A thought-provoking piece – but a challenging paper to discuss!
Overview

Two parts of the paper

1. Expectations and chronic inflation in EMs
   - Seigniorage and fiscal dominance
   - Inflation expectations, credibility
   - Staggered price setting

2. Liquidity crunches and chronic deflation
   - The ‘backing’ of money and other liquid assets
   - Liquidity deflation
   - Liquidity shortages and the sluggish recovery
Overview

• Depart from pre-crisis conventional macro models
  – Little attention to the financial side – other than a stable demand function for well-defined ‘money’

• Shift focus to broader (and blurrier!) ‘liquid’ (or safe) assets – those that facilitate transactions
  – Easily transformed into means of exchange
  – Used as collateral, so key to unlocking the credit channel
  – But also subject to runs a la Diamond-Dybvig: multiple equilibria
  – Expectations / coordination play a critical role

• Provide a liquidity-based explanation of the global crisis and the sluggish recovery
Overview

• Large literatures concerned with similar issues
  – The ‘safety trap’ (e.g., Caballero and co-authors)
    • Growing shortage of safe assets
    • Asset destruction in the crisis drives their rate of return to the ZLB
  – Rational bubbles under frictions (e.g., Martín and Ventura)
    • Bubbles as collateral that allows raising credit and investment
    • Bubbly collateral is sustained just by ‘market sentiment’: boom-bust cycles as sentiment changes and bubbles form and burst

• Many insights similar to those in this paper
  – More discussion of parallels and differences would be useful – especially regarding policy implications
The ‘backing’ of money

• The ultimate liquid asset: fiat money
  – An intrinsically worthless asset, valuable only if valued by others i.e., a bubble
  – Gives raise to multiple equilibria with self-fulfilling expectations, fully consistent with rationality

• A ‘Price Theory of Money’ (PTM)
  – nominal price inertia anchors money’s purchasing power
  – money is valuable liquidity today because it was yesterday
    A drawback of price flexibility (and flexible exchange rates)?
    Tradeoff against ease of adjustment to real shocks
    And are pricing arrangements exogenous to money stability?
Liquidity and fragility

• Other assets beyond fiat money provide liquidity services
  – Including privately-produced (near-)safe assets (e.g., ABS) created to meet the growing demand for liquidity
  – in U.S., net supply negatively correlated with supply of public debt (Krishnamurty and Vissing-Jorgensen 2012)

• They are vulnerable to self-fulfilling runs (unless fully backed by a LoLR), as in the global crisis
  But what triggers those runs (‘shifts in sentiment’)?
  – Not evidence of ‘large’ shocks to fundamentals
  – Over-reaction to ‘news’? – as in settings with heterogenous information (‘beauty contests’, Allen et al 2006)
Liquidity and fragility

- Private-label safe assets are free from idiosyncratic risk (‘information insensitive’) but not systemic risk
  - Their use raises financial fragility (Gorton and Ordoñez 2013)
  - This can make safe public debt welfare-raising – i.e., net wealth

- A natural question: what forms of liquidity would be preferable – i.e., more efficient / less fragile?
  - e.g., commodity money-like assets that have intrinsic value (Fischer 1986; Eden and Kay 2015)?

- How is fragility affected by financial regulation?
  - Little mention in the paper, except for the regulation-induced increase in demand that tends to worsen liquidity shortages
The sluggish recovery

• A liquidity-centered explanation: credit *supply* grinds to a halt with the destruction of safe assets
  – How to disentangle from a drop in credit *demand*?
    • Many firms in U.S. (and Japan) are awash with liquidity
    • Most asset prices have seen large increases post-crisis

• Policy should aim to restore liquidity
  – Asset purchases (QE1)? Enhancing securitization capacity?
  – A *supply-side* (not a Keynesian!) liquidity trap
    • Monetary expansion fails to raise liquidity services
    • It may even lead to *deflation* as agents compete for more liquidity!

• What about fiscal policy – especially if financed with (safe) public debt? (e.g., Caballero and Gourinchas 2016)
The destruction of safe assets
Emerging markets

• Largely innocent bystanders, vulnerable to *sudden stops*
• Self-insure mainly through reserve hoarding
  – but this adds to the safe asset demand (close to $10trn today)
    • part in support of undervalued exchange rates
  – Negative externality that worsens global liquidity shortages and fragility
  – More insurance / pooling mechanisms are needed
  – Rogoff (2016): EMs should shift to gold as reserve asset
• What reforms would make (at least some) emerging markets add to the supply instead?
  – Asset markets, governance, fiscal frameworks...
Big pending questions

• What triggers liquidity crises?
  – Some covariates – but are they robust predictors?
  – Experience with EWS not that great

• Welfare: to what extent is the growth in ‘liquidity’ welfare-enhancing?
  – Demand comes primarily from the growing needs of the financial system. Can it grow too large?
  – Demand reflects financial frictions. Should the response focus on expanding supply, or trying to mitigate frictions?
  – How can financial regulation help?