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Financial Frictions, Foreign Currency Borrowing, and Systemic Risk

Tanju Yorulmazer
Federal Reserve Bank of New York

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Giovanni Dell'Ariccia   Luc Laeven   Robert Marquez

Discussion by

Tanju Yorulmazer
New York Fed

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Channels for systemic risk and contagion

- Presentation at the Turkish Central Bank

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- Interbank exposures

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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 <u>and</u> 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).