Discussion of Ma and Wei's

"International Equity and Debt Flows to EMEs: Composition, Crises, and Controls"

by Anton Korinek

UVA Economics and Darden, NBER and CEPR

May 2021

ABFER 8th Annual Conference: International Macro, Money & Banking

Summary

- Paper provides a theory of countries' external capital structure
  - Based on notion that equity generates greater moral hazard than debt
  - And institutional quality counteracts moral hazard incentives

→ More developed countries use more equity
  → Are better insured
  → Experience fewer crises
  → Have less need for capital controls

- Will provide more extensive comments in person

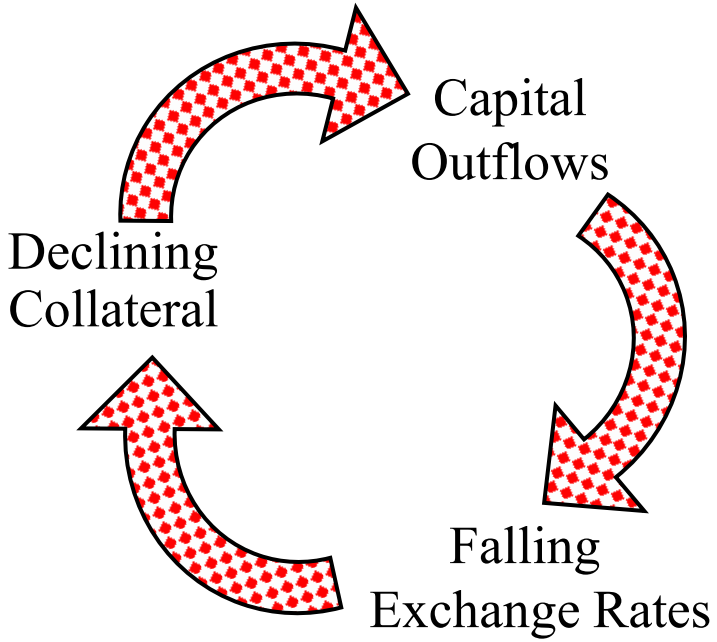
Background: Pecuniary Externalities

Incomplete financial markets generate two types of pecuniary externalities (Davila and Korinek, 2018):

- Distributive externalities: when agents are imperfectly insured, and price movements change agents' terms-of-trade to improve insurance
- Collateral externalities: when agents are subject to price-dependent financial constraints

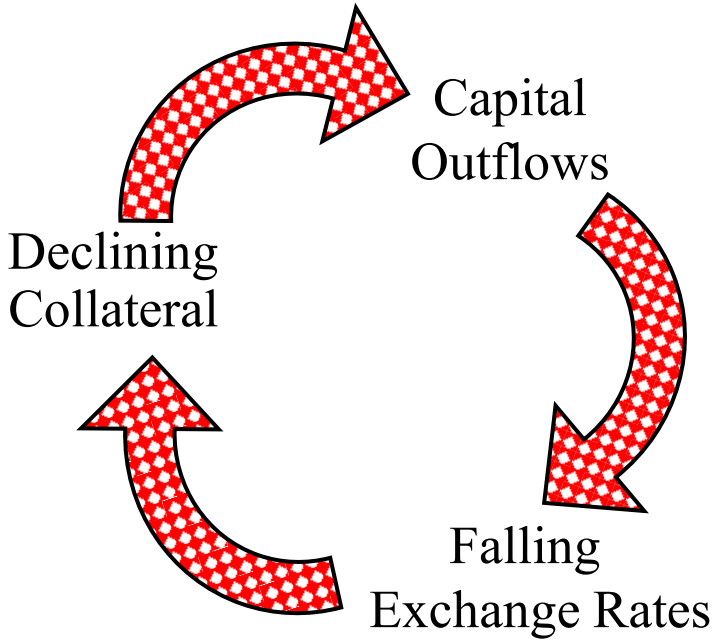
Background: Pecuniary Externalities

This paper: collateral externalities

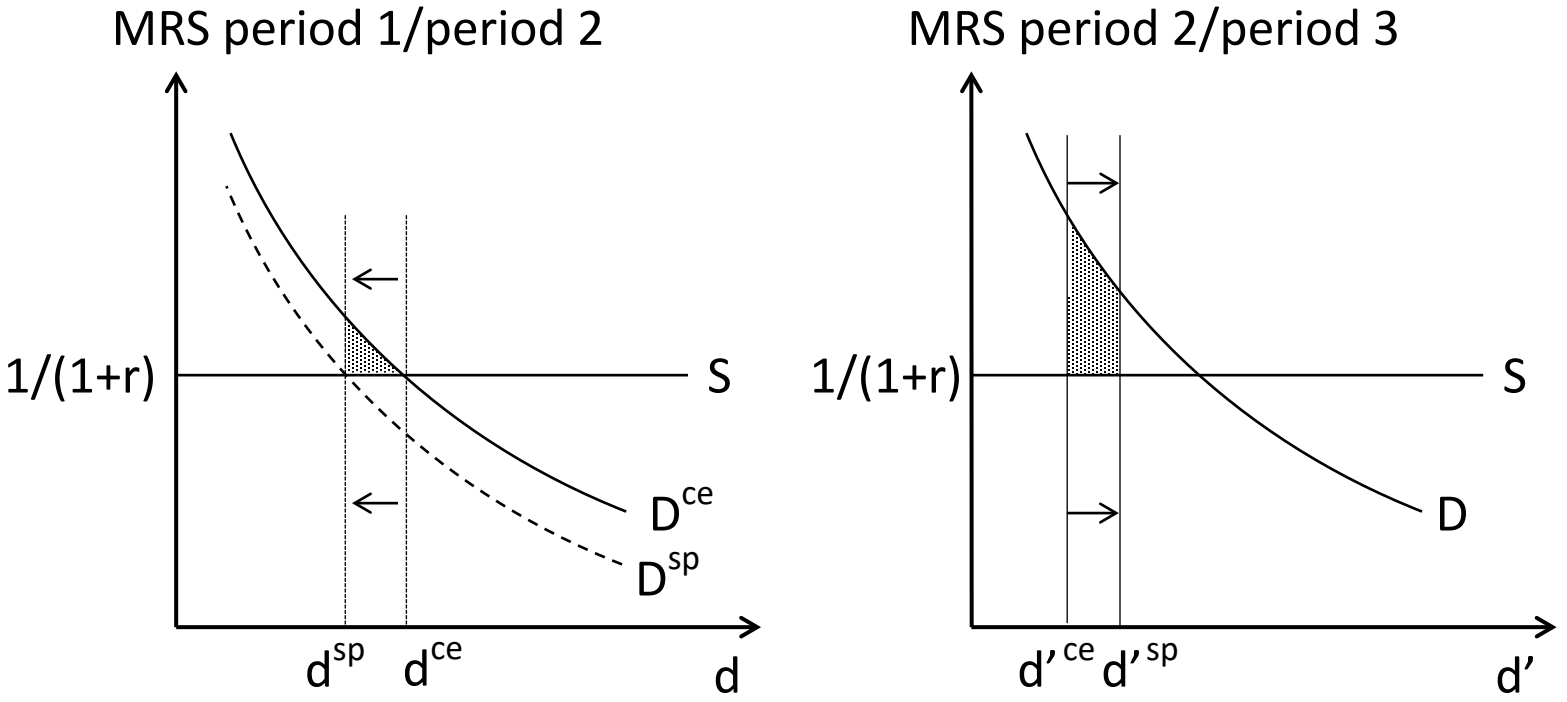


Background: Pecuniary Externalities

This paper: collateral externalities



Background: Pecuniary Externalities and 2nd-Best Interventions



Pecuniary externalities and capital structure

- Described collateral externalities arise in any state of nature in which the collateral constraint binds
  - Typically, constraint is tightest in bad states of nature
  - Equity contracts entails much smaller repayments than debt in those states

  → smaller externalities
- General formula for tax t_x on security x:

$$t_x = E[\tau^\omega \cdot x^\omega]$$

where τ^ω … externality kernel (externality in state of nature ω) and x^ω … state-contingent payoff

Pecuniary externalities and capital structure

For example, in Korinek (JIE 2018):

Asset category	Real gross return	Externality in 1998	Optimal tax
Dollar debt	218%	30.7%	1.54%
GDP-indexed dollar debt	190%	26.8%	1.34%
CPI-indexed rupiah debt	100%	14.1%	0.71%
Rupiah debt	63%	8.9%	0.44%
Stock market index	44%	6.2%	0.31%

Empirical findings

Fact 1: institutional quality ↗ share of equity financing

Fact 2: share of equity financing ↘ crisis probability

Fact 3: institutional quality ↘ use of capital controls

Comments:

- Much of this probably driven by AEs vs EMEs/DEs
- External equity financing/GDP is better indicator of a country's insurance

Main Contribution: Model of Capital Structure

Tirole-style moral hazard problem that is linear in amount raised

- MH problem is set up for both debt & equity
- then assumed away for debt
- but collateral constraint on debt is imposed

→ It would be cleanest to derive both from (the same) microfoundations

Debt vs Equity

Tirole-style moral hazard problem that is linear in amount raised

- Gives rise to “iceberg cost” of equity θ
- Debt vs equity = return vs insurance
- Greater institutional quality allows for more insurance

Propositions 4 & 6: competitive equilibrium and planner feature:

- only debt if θ too high
- debt and equity otherwise

(case of equity only is unlikely unless $\theta \leq 0$)

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