

# Global Flight to Safety, Business Cycles, and the Dollar

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# Overview

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# Summary

## Summary of the paper

- Builds and estimates a two-country DSGE model augmented by financial frictions (Gertler and Karadi, 2011) and **time-varying preference for safe assets** (to capture **global flight to safety** shocks)
- GFS shock  $\zeta_t^{GFS}$ : common to Home and Foreign but allowed to affect them **asymmetrically** (captured by  $\gamma$ )
- Bayesian estimation favors asymmetry and dollar specialness (i.e.,  $\gamma = 0.3 > 0$ )
- GFS shocks alone explain a bulk of variation in both US and RoW macroeconomic aggregates (up to 30% of world GDP growth)

## Contribution of the paper

- Provide a very nice way to incorporate the special role of Dollar assets into a quantitative model
- Fill the gap in the literature by **quantifying** the role of GFS shocks using an open economy DSGE model with various shocks and frictions
- Decomposition exercise is very helpful in understanding exchange rate movements
- I really enjoyed reading the paper and came up with a few questions and suggestions

# Major Comments

## How to think of GFS shocks?

- GFS shocks affect both US and foreign households' preference for safe assets
- If  $\gamma > 0$ , GFS shocks have asymmetric effects between US and foreign safe assets (reduced-form characterization of convenience yield)
- Micro foundation: What is the source of GFS shocks? Beyond the scope of this paper but US monetary policy can be its source (Miranda-Agrippino and Rey, 2020)
- However, quantitative exercises placed only a minor role on US MP shocks in global business cycles (in contrast to earlier studies on US monetary spillovers)
- Fundamental question: common shocks vs. spillovers?

## How to think of GFS shocks?

- Are GFS shocks orthogonal to contractionary US MP shocks?
- **Model:** Simulated IRFs to GFS shocks resemble the typical response of macro aggregates to contractionary MP shocks (as if **negative AD shocks + RER appreciation**)
- However, the model assigns a very limited role to US variables in explaining foreign variables (1.7% of GDP growth, 1.4% of consumption growth, and 0.5% of policy rate)
- Is this result specific to the way GFS shocks are modelled? I will get back to this point later



## How to think of GFS shocks?

- Are GFS shocks orthogonal to contractionary US MP shocks?
- **Empiric:** Currently, GFS shock is proxied by excess bond premium (EBP) and no variable captures monetary policy in the VAR. Are GFS shocks really identified?
- This is important given the interaction between monetary policy and financial conditions
- Recent study on GFS (Ahmed, 2023) also emphasized that the orthogonalization of GFS shocks to MP shocks matters
- Currently, no variable capturing international capital flows (a crucial condition that GFS must satisfy)
- Would be great to provide more discussion about how to think of GFS shocks given the well-known narrative of US monetary policy spillovers

## Alternative modelling of GFS shocks

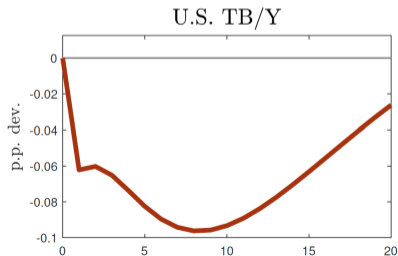
- The model has Gertler and Kiyotaki (2010) style of banking frictions:  
$$V_t \geq e^{\zeta_t^{\kappa} + \bar{\zeta}_t^{\kappa}} \kappa Q_t K_t$$
- $\bar{\zeta}_t^{\kappa}$  can be interpreted as a global shock to collateral constraint
- It is possible that US safe assets are better collateral than foreign safe assets (Devereux et al., 2023)
- Analogue to the current modelling of asymmetric GFS shock,  $(1 + \gamma)\bar{\zeta}_t^{\kappa}$  may capture this inherent difference

## Alternative modelling of GFS shocks

- Currently, financial shocks matter little for macroeconomic aggregates other than corporate spreads (in contrast to a voluminous literature on credit spread and business cycles)
- However, allowing for  $\gamma > 0$  may increase their role in accounting for global business cycles (given the quantitative nature of the paper)
- If so, how would it affect the estimation of original  $\gamma$  and the importance of GFS shocks? In other words, which type of GFS modelling is favored by data?

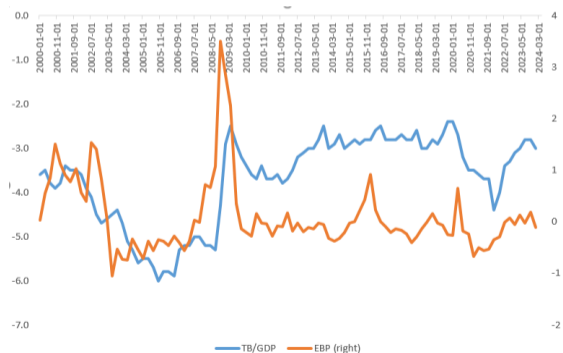
## Exorbitant privilege and wealth transfer

- Lack of US holding of foreign assets ( $B_{F,t}$ ): unclear how **NFA** is defined in the model
- Behavior of NFA, especially during the GFC episode, is something that a model of GFS must explain
- This paper instead looked at the model response of the US trade balance (worsening trade deficit mainly due to real appreciation)
- What about the VAR evidence?



# Exorbitant privilege and wealth transfer

- Is it consistent with data? During the GFC with heightened EBP, trade balance and current account improved despite the real appreciation
- I expected more discussion on NFA and CA dynamics as well as the valuation effect of GFS shocks through the lens of the model

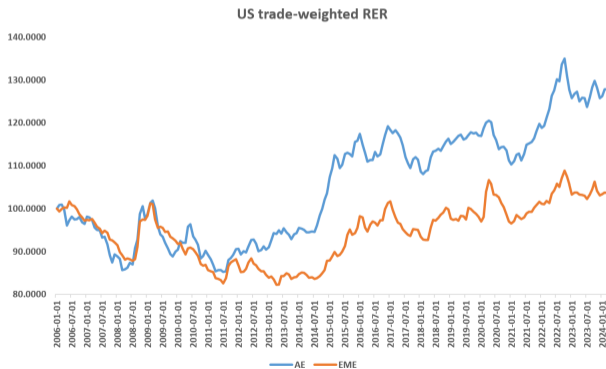


## Potential heterogeneity in the RoW

- Given the conceptual definition of GFS shocks, the foreign country corresponds in the model to the RoW in the data
- The presence of other safe havens (e.g., Japan and Switzerland) in the data and the lack of US holding of foreign safe assets in the model makes EMEs more natural counterpart
- Would be interesting to see whether the behavior of the estimated model differs between AEs and EMEs
- Particularly regarding the parameter  $\gamma$  given the diverging RER behaviors in the last decade

# Potential heterogeneity in the RoW

- Much larger RER depreciation of AEs than EMEs during the sample period
- What would data speak about the role of GFS shocks for AEs vs. EMEs? Are they consistent with our prior?



## Minor Comments



## Untargeted moments

- Another dimension the model may do better is the Backus-Smith puzzle
- What do the full model and the model with a GFS shock only tell about  $\text{corr}(\Delta \log \mathcal{E}_t, \Delta \log C_t - \Delta \log C_t^*)$ ?

## Trade parts of the model

- The model assumed LCP: Is it a good assumption for modelling the dominance of the Dollar?
- Does anything change if DCP is adopted?

## Details on data

- Elaborate on how corporate bond spreads for the RoW are obtained, as they are not readily available for many countries