Banking Limits on Foreign Holdings:

Disentangling the Portfolio Balance Channel

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Main ideas

- Interesting paper that hast two contributions:
  1. Sets up a model of UIP deviations where Central Bank assets do matter to affect the exchange rate
  2. Finds empirically that these UIP deviations do matter
- Akin to recent literature of portfolio balance channel of FXI
  1. Gabaix & Maggiori (International Liquidity and Exchange Rate Dynamics, QJE, 2015)
  2. Cavallino (Capital Flows and Foreign Exchange Intervention, AEJ: Macroeconomics, Forthcoming)
  3. Fanelli & Straub (A Theory of Foreign Exchange Interventions, 2018)

Comment 1

Seems that model part does not fit clearly with empirical part

1. Model is about households decisions to hold assets vis-a-vis Central Bank
2. Banks are assumed away. However, limits apply to banks FX positions. With the aim to reduce mismatch risks.
3. If banks and households were modeled, presumably high household demand for USD assets may imply higher bank USD liabilities.
4. This means that as households get closer to the upper regulatory limit, banks get closer to the lower limit.

Comment 2

Whenever there is a limiting equilibrium, it would be nice to clearly see if the exchange rate is below or above the constant equilibrium

$$e_1 = \frac{1+r}{1+r^*}\left(1 \underbrace{- \frac{1}{\tilde{B}} - \frac{(1+\beta)A_0}{B_G^*}}_{\text{wedge}}\right), \quad \textit{for} \;\; \tilde{B} \in \{\overline{B}, \underline{B}\} \qquad (1)$$

1. Is the wedge positive (e_1 below $\frac{1+r}{1+r^*}$) whenever $\tilde{B} = \underline{B}$? (households do not want USD assets)
2. Is the wedge negative (e_1 above $\frac{1+r}{1+r^*}$) whenever $\tilde{B} = \overline{B}$? (households do not want peso assets)

Comment 3

On he empirical part

- There are some negative observations in the density plots (McCrary's Test). What do they mean? Didn't banks comply with the regulatory limit?
- Do results show that whenever banks assets and liabilities are matched there is exchange rate depreciation pressure?