Destabilizing Carry Trades by Guillaume Plantin and Hyun Song Shin

Discussion by
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Why are carry trades profitable?

- It seems like any easy trade to profit from
- Borrow the low interest currency at the same time you lend in the high interest currency
- Works because UIP does not hold
- Profits are persistent: momentum strategies work

Is there a solution to the puzzle?

- Compensation for risk is an option, but conventional risk measures cannot account for profitability
  - Fama-French market factor is signficant in factor regressions, R^2 small
  - Currency based factor models also have low R^2
- Peso Problems/Disaster risk has potential
  - Significant profits in 2008 recession from momentum strategy (Burnside, Eichenbaum, Rebelo 2011)
- These explanations can account for a part of the puzzle, but still a puzzle

This paper puts a novel new explanation forward

- Currency Traders coordinate on a country when they observe positive shocks to interest rate differential
- Positive currency trade profits draws more capital in
- The currency appreciates, raising expected profits on carry trade
- With succesful coordination sustained profits possible (momemtum strategy works in model)
- Negative interest differential shocks eventually lead to a sharp reversal

Key Assumption: Flexible Traded Goods Price, Sticky Non-Traded Prices

- This is the most critical assumption of the model
- Traded goods prices are a small part of the economy, and flexible
- Deflationary shocks from the carry trade appreciate the currency more than CPI inflation
- Currency appreciation is critical: it must overcome the fall in domestic returns with carry trade inflow

Key Assumption: Flexible Traded Goods Price, Sticky Non-Traded

- Why are the two sectors so different?
  - Huge sectoral differences in Calvo mechanism seems unlikely
  - Information processing or rational inattention seems more plausible
  - Traded goods prices are 'dock' prices
    - Burstein, Eichenbaum, Rebelo, *JPE*, 2005
  - Non-traded goods prices transactions in the economy
  - May be rational for importer to pay close attention to prices of the small number of traded goods
- Comment: Other theories are plausible explanations, but empirically did not work
  - How large a differential in size and stickiness do we need for this theory to work in practice?

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Key Assumption: Central Banks Target Inflation

- If the central bank targets exchange rates (or asset prices) carry trades according to this theory will not work (very well)
  - Exchange rate appreciation is a key mechanism in the model
- Empirical Prediction: Carry Trades should work better in purely inflation targeting countries

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Evidence on Currency Trade Returns and Inflation Targeting

- Burnside (2014) reports currency trade returns for 45 countries
- I sorted by IT and Non-IT
- Caveat: Return calculation period and IT period do not have exact overlap
- IT countries yield greater return

	Return	Sample Size
IT: All Countries	0.050	22
Non IT: All Countries	0.036	21
IT: Emerging	0.049	17
Non IT: Emerging	0.034	19

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Evidence on Currency Trade Returns and Inflation Targeting

- Are IT countries riskier?

	Return	Sharpe Ratio	Sample Size
IT: All Countries	0.050	0.392	22
Non IT: All Countries	0.036	0.417	21
IT: Emerging	0.049	0.362	17
Non IT: Emerging	0.034	0.408	19

Policy Implications of Destabilizing Carry Trades

- Include exchange rates/asset prices in policy rule should limit destabilization
- Require holding period for new capital inflows
  - Investors will be concerned they can't get out when crash starts
  - Indonesia use this during the great recesion
- Taxes on capital flows likely will not work
  - Lowers return, but return can still be large enough to motivate trading
  - Brazil in 2009 use such taxes

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Conclusion

- Intesting new theory of carry trades
- Relies on 1) Flexible traded goods prices and 2) inflation targeting
- An informal evaluation of the empirical evidence seems to favor the theory in the paper
- It would be interesting for future work to work on quantitative version of the model