DISCUSSION

EUGENE FLOOD*: Alan Shapiro's paper entitled "Currency Risk and Country Risk in International Banking" is a timely one in a subject area whose popularity is growing. These comments are written in suggestion form, and their purpose is to suggest areas in which the paper might be strengthened. The comments will be directed in three areas of the paper.

1. The nature of the equilibrium referred to in the section on currency risk and firm borrowing.
2. The direction of causation between exchange rates and prices.
3. Foreign currency risk and country risk in country borrowing.

I. International Capital Market Equilibrium with Default Risk

In Section I of the paper, Currency Risk and the Firm, Shapiro makes the statement that " . . . in equilibrium, banks should be indifferent between lending in one currency or another." This statement is the kind of statement that is attractive to economists. While it sounds plausible, it is unfortunate that the nature of the equilibrium is not carefully described. By specifically addressing default risk, Shapiro is presumably attempting to explicitly model a world in which the total risk of the firm matters (not only the systematic risk) to banks and possibly other financing agents. The problem is that this type of equilibrium is not a trivial one. Consider a two-country world in which three standard equilibrium conditions hold on an expected value basis: (i) the law of one price; (ii) purchasing power parity; and (iii) interest rate parity. Furthermore, assume (as Shapiro does) that there is no general price inflation in either country. This implies that there is no expected move in the nominal or real exchange rate. Now suppose a firm has a cash flow exposure to exchange rate changes. Then, in general, there will be states of the world in which borrowing in one currency will lead to default but will not lead to default in the other currency. Depending on the probability of the states, firms and banks will have a preference for borrowing and lending in a particular currency. Or viewed another way, to make firms and banks indifferent between borrowing and lending in the two currencies, the interest rates would have to be different. But if there is no expected move in the exchange rate, then interest rate parity would break down.

There are a variety of international asset pricing models in the literature which use perfect markets assumptions for goods and capital markets with varying degrees of severity. See, e.g., Black [1], Grauer et al. [4], or Stulz [6, 7]. Different assumptions will, of course, lead to different implications. Given the specific concern with default risk here, it would be helpful if Shapiro would explain how the equilibrium he has in mind relates to the others mentioned here or elsewhere.

II. Causation Between Exchange Rates and Prices

While it is clear that Shapiro believes that relative price changes cause exchange rates to change (footnote 2), it is not at all a settled point in the literature.

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Shapiro points this out. People are sometimes confused by this discussion and how it relates to the exposure literature. The important point, as Shapiro indicates, is not the direction of causation, but the correlation between prices and exchange rates which determines exposure.

III. Foreign Currency Risk and Country Risk in Country Borrowing

In this section of the paper Shapiro discusses political risks in country lending. The absence of acknowledgements in this section of the paper of the large body of previous work done in the area is surprising. Shapiro provides a discussion which is similar, but less rigorous and less complete than other broad survey papers such as Cooper and Sachs [2]. The following illustrations are examples of the types of additions that other authors in this field have made that would strengthen the Shapiro paper. Cooper and Sachs [2] show the usefulness of discussing country borrowing risks in three categories: (i) solvency risk which is the country's long-run ability to repay; (ii) liquidity risk which is the inability to service debt in any single period without further borrowing; and (iii) repudiation or default risk. Sachs and Cohen [5] provide a richer menu of the costs to a country of default. In addition to partial or complete inability to obtain future loans in foreign debt markets, there may be direct seizures of a countries overseas assets or a decline in their ability to engage in foreign trade. With an analytical model Eaton and Gersovitz [3] provide some interesting insights on default risk. Among other things they show that, counter to first intuition, variance in a country's income could conceivably lead to a higher debt ceiling or capacity, not only because of a greater ability to repay debt in the prosperous part of the cycle, but also because the implicit cost of being shut out of the debt market is very high so that maintainance of high long-run utility requires that they not default.

In conclusion, I believe that this paper could be strengthened by further attention to the nature of the equilibrium discussed in the first section and further exploration of the literature for the second section.

REFERENCES

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