

Research Statement

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My research interests are in international finance and macroeconomics, particularly in the area of financial frictions. Such frictions affect the ability of emerging market economies to access international capital markets, and the capacity of private firms to borrow funds. Much of my work, including my job market paper, concentrates on capital flows and emerging market borrowing. I characterize optimal policies for the government and for international financial institutions in the face of specific market imperfections. In addition, I consider models that relate financial frictions to the allocation of capital across firms for a given economy. Optimal government policy for firm bailouts is characterized in this context.

My job market paper, “Sovereign Debt and Domestic Economic Fragility,” examines borrowing by the governments of emerging market countries. My model framework assumes that governments cannot contractually commit to repayment of their debt, and that economic activity in the domestic production sector is limited by financial sector liquidity. Government debt is held by both foreign and domestic lenders, and the government is constrained to default equally on both. Default on foreign lenders benefits domestic consumption, but default on domestic residents generates an output cost by reducing liquidity in the financial sector. I present two sets of results. Firstly, I characterize the optimal default decision by the government and relate it to both the productivity shock and inherited debt variables. If the domestic banking system is sufficiently exposed to the adverse effects of default, the government does not fully repudiate its debt and this in turn means that debt can be sustained even in the absence of reputational mechanisms. Secondly, I characterize the optimal debt issuance decision by the government. The government structures its debt issuance policy so as to manipulate the domestic economic costs of default in future periods. High domestic exposure to such costs enables the government to borrow more ex ante. Furthermore, the government may manipulate the level of domestic economic activity so as to affect the willingness of domestic banks to hold its debt. I evaluate different policies by international financial institutions within my model framework. In particular, recommendations for the domestic economy to reduce financial sector fragility may have the counterintuitive side-effect of a reduction in the ability of the government to borrow.

Borrowing by private sector firms on international capital markets is the subject of my work entitled, “IMF Crisis Intervention and Moral Hazard.” In particular, I examine the relationship between government policies, IMF transfer schemes and capital market access by the private sector. I show that IMF intervention in moments of crisis can actually ameliorate rather than worsen the government’s moral hazard problem. I develop a model with informational frictions and imperfect private sector insurance. Government policies can improve the economic fundamentals of a country, and the government learns of the success of its actions before foreign investors. In this context, the optimal IMF policy seeks to reveal the private information of the government to foreign investors. The IMF provides limited transfers to countries which declare themselves to be in a crisis. Private firms in these countries face high interest rates on international capital markets. Countries which do not accept transfers are identified as having strong fundamentals and are rewarded with low interest rates on international capital markets. Private and official flows become negatively related. The key mechanism is that IMF crisis intervention improves the consumption of non-crisis countries, by inducing a separating equilibrium ex post. In the absence of such transfers to countries in crisis, the separating

equilibrium does not exist, which in turn reduces the incentives of the government ex ante to engage in desirable policies. Therefore, IMF crisis intervention ex post can improve government incentives to pursue policies that strengthen economic fundamentals.

The framework described above can be reinterpreted as a model of the allocation of capital across firms for a given economy. In this case, it is domestic firms who engage in productivity-enhancing investments before the production stage. The success or otherwise of such investments is private information to the firms. In the absence of government help for struggling firms, it may not be possible for financial markets to discern the quality of firms in the production sector. A policy of limited government bailouts for struggling firms induces a separating equilibrium. It enables the market to direct financing to those firms that reject government help because they are fundamentally sound. Firms exert higher effort in improving productivity ex ante because the bailout of unsuccessful firms improves the rewards to successful firms. Such a model yields the counterintuitive result that anticipation of government bailouts for the worst performing firms may improve the incentives to engage in productivity-enhancing investments.

In my research project, “Optimal Crisis Transfers in a Repeated Dual Agency Framework,” I examine the interaction between private and official capital flows under another financial friction. My model framework incorporates the fact that government policies affect the productivity of domestic firms, but the government is not party to contracts signed between private firms and foreign lenders. In particular, there is a time inconsistency problem because government policies to improve domestic economic productivity are undertaken after foreign investment is sunk. For this environment, it can be expected that unconditional IMF transfers in moments of crisis may diminish the incentive for the government to enact sound policies ex ante. In a dynamic model, the IMF may seek to counteract this effect, in part by conditioning the magnitude of crisis transfers on prior economic performance. My model aims to characterize the optimal relation between future promised transfers and current economic performance.

Unanswered questions from my current research, as well as recent world developments, should shape my future research agenda. My job market paper makes a general point and a more specific one. The general point is that domestic economic exposure to the adverse consequences of default helps the government “purchase commitment” to make repayments in future periods. Beyond the specific model framework I have employed, it would be interesting to explore other measures of domestic economic exposure, which may encompass other measures of vulnerability in the domestic financial system. My work on IMF intervention and moral hazard raises the question of how to identify whether countries are experiencing solvency or liquidity problems. In particular, it may be difficult for international financial institutions to aid countries with liquidity problems, if the acceptance of official financing carries with it the stigma of possible solvency concerns. In this case, the optimal transfer policy by the IMF should be designed so as to separate these groups of countries as well. Similar concerns apply to the provision by the government of liquidity support to domestic firms.

Overall, my expectation is that the study of the nature of financial frictions should help me both to obtain an improved understanding of the functioning of capital markets, and to derive policy-relevant prescriptions to alleviate the welfare consequences of such frictions.