

Capital Flows and Financial Stability

Discussion of Curcuru et al., Correa et al. and Igan and Tan

Conference on Capital Flows, Systemic Risk and Policy Responses
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The views expressed here are the author's alone and do not necessarily represent those of the IMF, its management, and/or board of directors.

Road Map

Nice papers!

Complement each other in both snap shooting at distinct transmission mechanisms MP → Kflows → domestic credit and using distinct approaches

So, one learns from these differences too

Next 12 mins or so:

- Will summarize main take-aways
- Highlight weaker links in the analyses/results which could be strengthened so to sharpen policy messages
- Relate some of the findings to those the latest issue of the IMF/WEO on the slowdown of capital flows to emerging markets

Take-Away 1

Bank cross-border flows can display very different a pattern from other cross-border flows and have a very significant impact on domestic credit conditions

- Correa et al.: Evidence of significant portfolio rebalancing by banks in response to changes in monetary policy, leading to substantial cross border diversification of loan portfolios.
- Igan and Tan: Bank flows can affect domestic credit conditions very differently from FDI and portfolio-equity

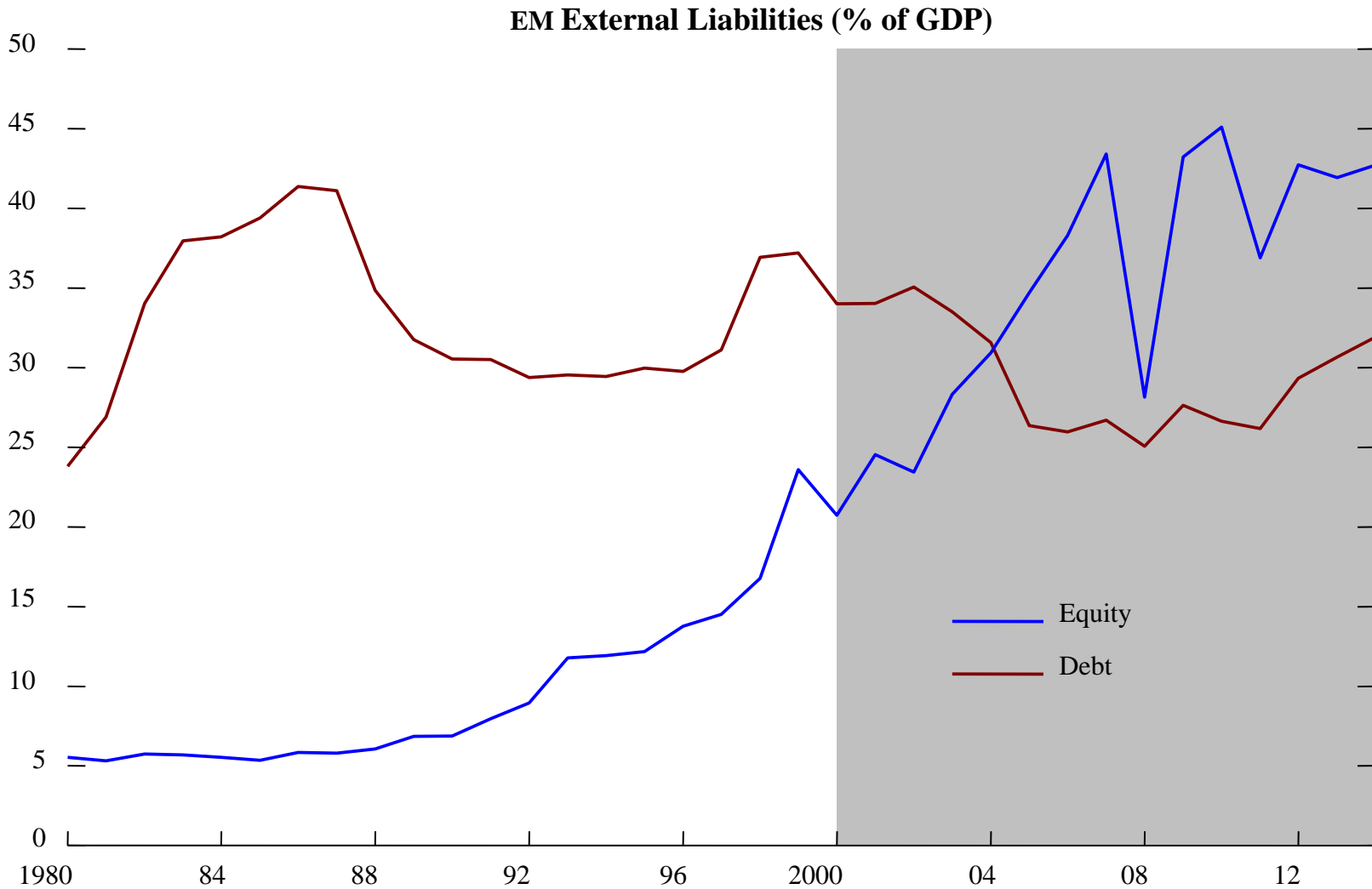
+ effects can be particularly strong in shallower financial systems and sectors that are more “financially dependent”

Take-away 2

Monetary policy changes in the US and other core countries now have more complex effects on Kflows than in the past

- Traditional Mechanism: $i_{us,uk} \uparrow \rightarrow$ K flows back to source countries, especially out of EMs. Well-documented in pre-1930, 1980s & 1990s.
- Curcuru et al. new evidence: Flows do not necessarily move straight back to the source country after tightening. Conversely, monetary loosening mostly leading to higher flows into other AE equity markets, not EMs
- Changes in monetary policy across core (US, EU, and Japan) more out of sync viz past \rightarrow complicates discernment of the net impact on recipient countries.
- Correa et al: Bank flows can behave at odds with the traditional transmission mechanism \rightarrow tightening can lead to capital **outflows** through the bank credit channel
- Big changes in compositions of EM liabilities, potentially making Kflows more sensitive to a broader host of factors

Take-away 2 (cont.)



Source: World Economic Outlook, April 2016

Take-away 3

Post-2007 monetary policy stances arguably harder to measure, with no consensual metric across studies → large discrepancies of results over similar episodes

- Curcuru et al (2015), EPFR data: “.. the main effect of unconventional monetary policy by DM central banks was to increase investment allocations of DM equity funds and decrease allocations of DM bonds, **EM bonds, and EM equities.**”
- Fratzscher et al. (2013), EPFR data: “Fed policies functioned in a procyclical manner for capital flows to emerging markets (EMEs) and a counter-cyclical way for the US, triggering a portfolio rebalancing across countries out of EMEs into US equity and bond funds under QE1, **and in the opposite direction under QE2.**”
- Cho and Rhee (2013), BOP data: “Empirical analysis shows quantitative easing, in particular the first round, significantly contributed to the rebounding of capital inflows to the (Asian) region...”
- Koepke (2014) & IMF/WEO (2016) with also EPFR data: Expectations of tighter FED policy are associated with large outflows from EM assets.

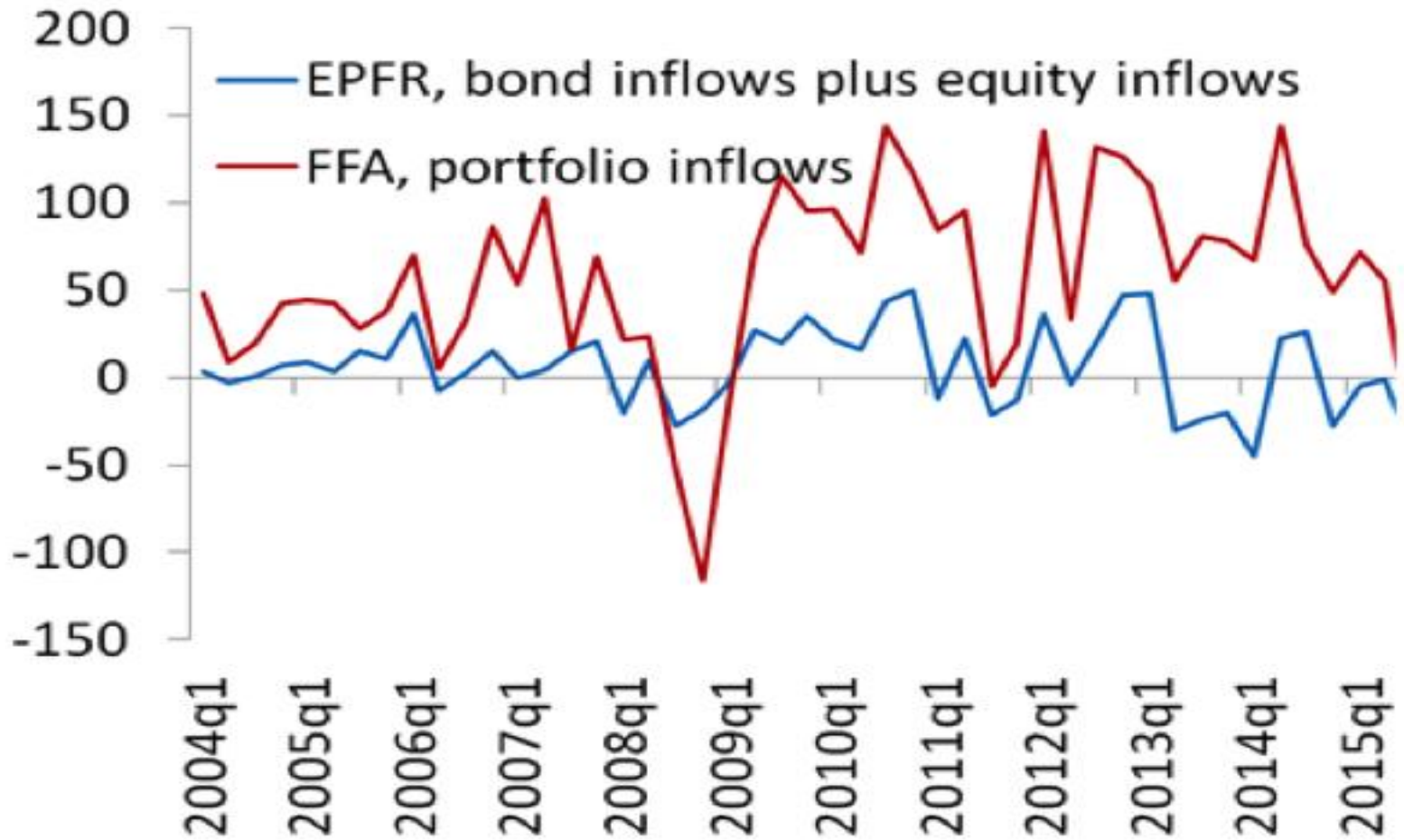


Specific Comments

Curcuru et al:

- As discussed, important to make effort to trace out the sharp difference of results with previous studies on the same event
- More controls in the regressions. Why leaving other available high frequency indicators out? E.g. VIX, commodity prices
- In particular, discuss why past flows are good proxy for expected future flows
- IMF/WEO 2016 results: important to distinguish changes in EM growth expectations (e.g. caused by major shocks to commodity price outlook – as in recent years) from AE MP shocks.
- More basically, is EPFR data always a good proxy for actual (BOP) Kflows?

EMEs: EPRF vs. BOP data

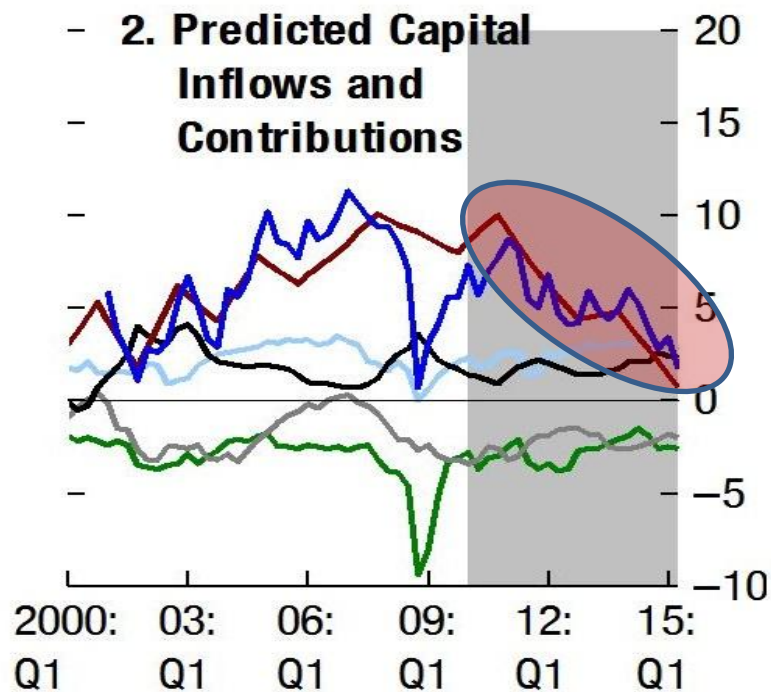
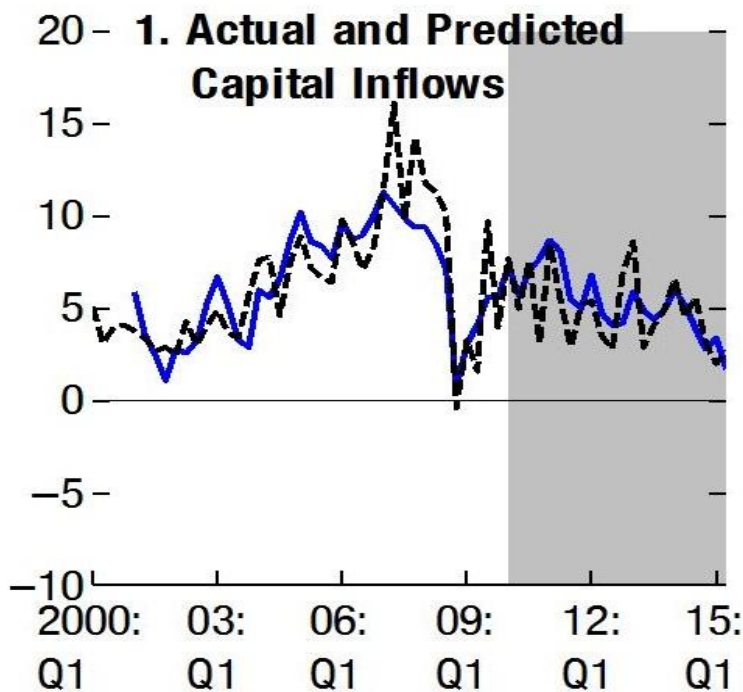


Cor level = 0.63

Cor growth rates = 0.07

Expected growth differentials seem key to explain recent developments in EM Kinfows, above all other financial factors ...

- Predicted capital inflows
- Growth differential
- Global risk aversion
- U.S. corporate spread
- Actual capital inflows
- Interest rate differential
- U.S. yield gap



Specific Comments (cont.)

Correa et al

- Is lagged policy interest rate properly identifying national monetary policy shocks?
 - Why levels of the policy rate and not changes? Over 1995-2014, the interest rate level is high trendy in AEs, so maybe not really picking up cyclical changes
 - Actual vs. expected changes
- Are we capturing “crisis” time vs. “normal” time effects? Much higher after 2007 than pre-2007 raises some concerns that crisis time effects dominate the estimates

Specific Comments (cont.)

- Controls could be more extensive:
 - Capital controls very relevant for some EMs in your sample going back to 1995 (cf. Igan and Tan paper & April 2016 WEO): May explain some diversion limited to AEs
 - Exchange rate regime and ER uncertainty (may explain stronger intra-eurozone diversion)
 - Lack of controls for banks' funding structures and other country-specific factors that may be time-varying (laundry list in Dynger and co-author, 2015 & de Haas & Van Horen, 2013)

Specific Comments (cont.)

Igan and Tan

- Nice application of RZ relating different degrees of FD to the extent that capital flows fuel domestic credit differently across countries
- Deserves a more prime-time show and cleaner presentation of this novelty. E.g. do a scatter of the reconstructed FD index on the growth of FDI, portfolio and OI-bank flows by country
- Authors duck the normative question of whether Kflow driven credit being “good or bad” but results say a bit on it, so why not highlighting it?

E.g. Since the Kflow-driven credit is stronger for higher FD sectors and countries with less developed financial systems, Kflow financing is helping mitigate domestic financial frictions → so “good” in principle

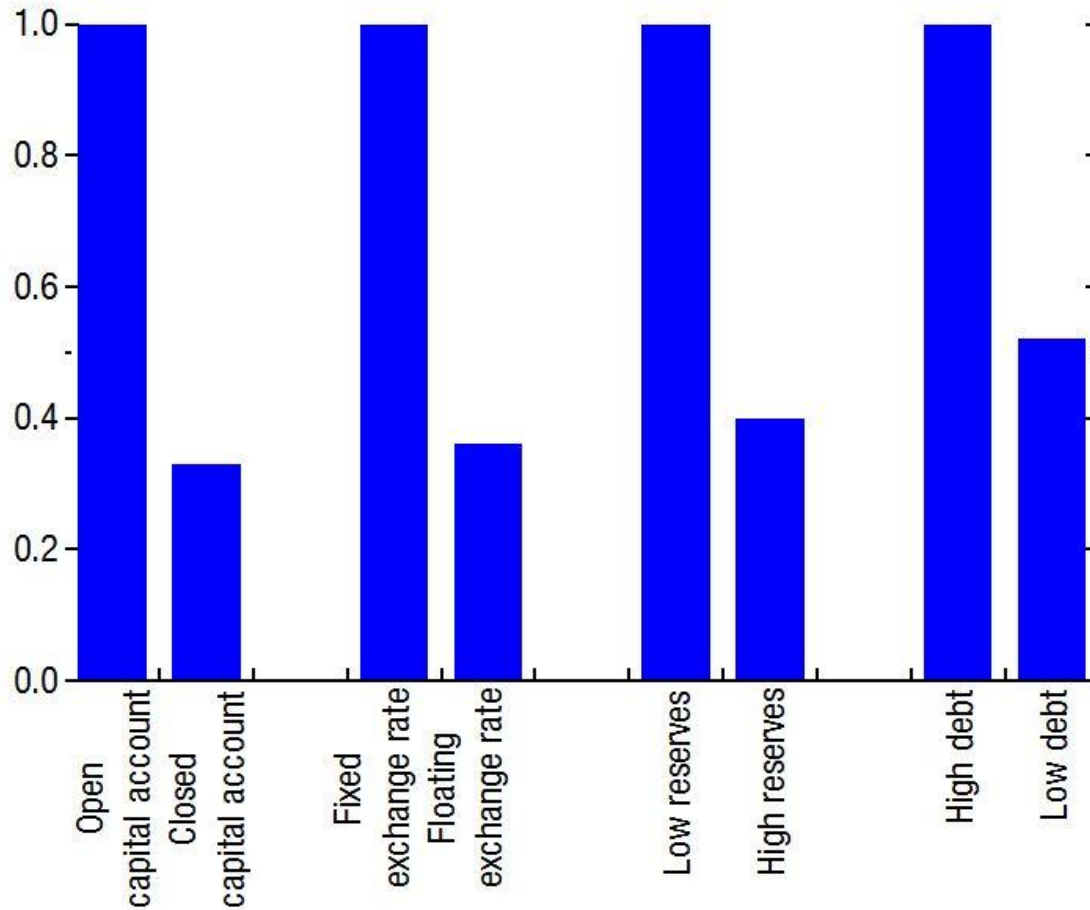
Specific Comments (final)

- In line with the findings of April WEO, interact the exchange rate regime indicator with FDI, PI, and Bank Flows at firm-level; and control lagged debt as in Correa et al and April 2016 WEO
- Found the identification of demand (for Kflow-financed credit) unconvincing: higher equity valuations may be themselves the effect of a “push” from the foreign supply of K flows
 - Suggestion: higher demand for credit should be associated with sectors that grow faster and/or where productivity is higher. Availability of firm-level data on employment, sales, and investment growth should allow you to test that.
 - Useful exercise anyways because examining whether credit goes into lower productivity sectors can be a helpful gauge of credit mis-allocation (Reis, BPOE 2013)

Thanks

Additional Slides

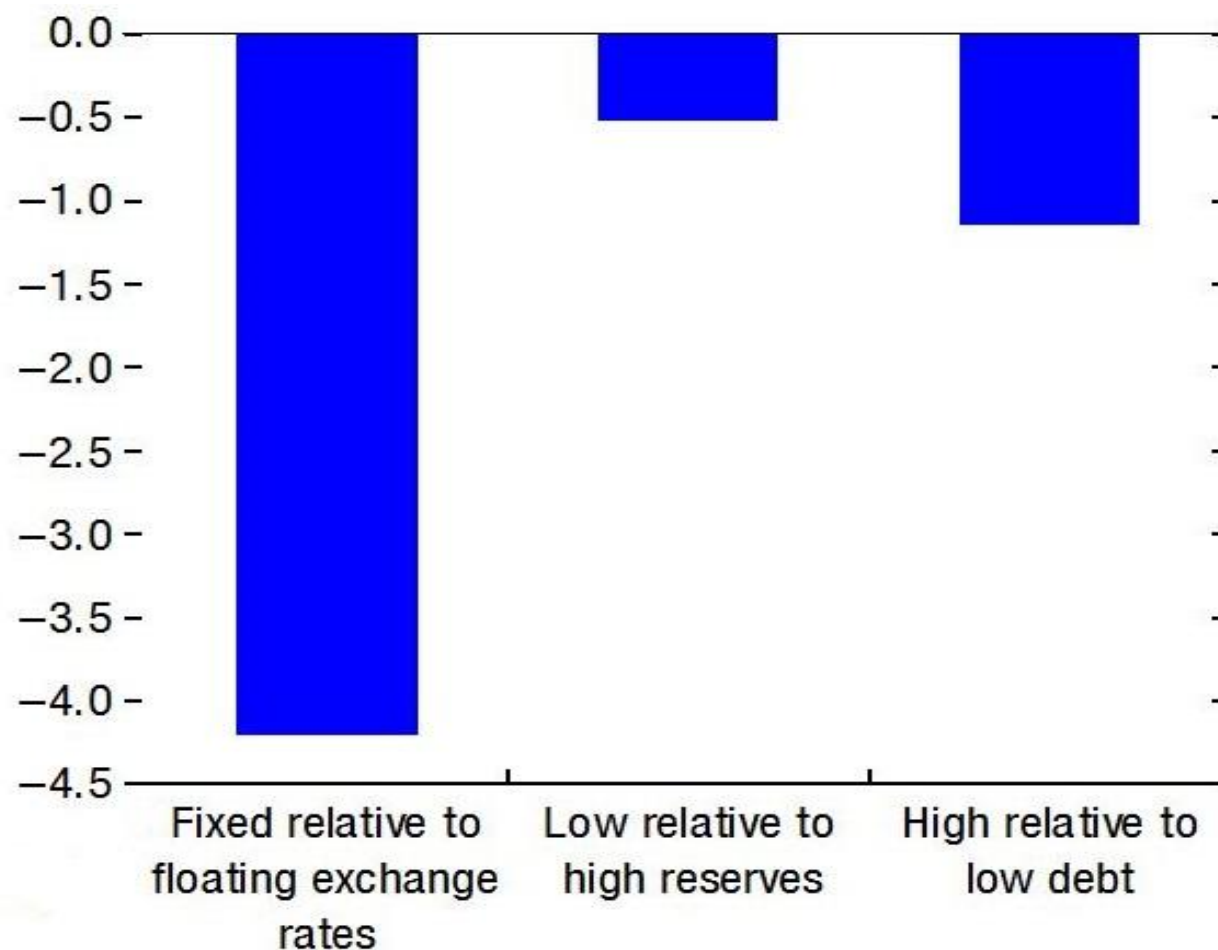
Share of Variation in Gross Capital Inflows to EMEs Explained by Global Factors 2000-2015



Source: April 2016 WEO

Differences in the Contribution of the Global Factor to the 2010-15 Capital Flow Slowdown Across Policy Regimes

(Percent of GDP)



Source: April 2016 WEO