



Discussion of Arias Garrido Parra Rincon “Do different types of capital flows respond...”

Frank Warnock

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The Plan

1. Main Takeaways
2. Suggestions
 - a. Some that are readily implementable
 - b. Others that would require effort
3. Conclusion

1. Main Takeaways

- Goal of the Paper:
 - Estimate a capital flow model for EMEs, assess determinants of flows
 - Analyze whether the different types of capital flows respond differently to fundamentals and if the relationships changed during the crisis
- Results:
 - Traditional pull and push factors still play a key role.
 - Their importance differs depending on the flow type.
 - The crisis seems to have caused a structural change in the relationship between capital flows and fundamentals.

1. Main Takeaways (some details)

- Goal of the Paper and Results :
 - Estimate a capital flow model for EMEs, assess determinants, see if they differ by flow type or during the crisis
 - Arellano-Bond Dynamic Panel Model, 49 countries 15 years of annual net capital flow data
 - Pull and push factors still play a central role in the determination of capital flows. But factors differ across type of flow.
 - In Table 2, only financial globalization indicator and total public debt are significant and same sign for all flow types. For other variables, coefficients differ (sign, size, statistical significance) across flow type.
 - From Table 4, the GFC affected the relationship between flows and their main drivers.

2a. Readily Implementable Suggestions

- As the authors note, this is a reduced-form empirical exercise. But what does theory suggest?
 - We'd expect the factors that drive different types of flows to differ. Simple example: equity v. debt
 - Perhaps could choose explanatory variables a bit more carefully.
- What do you really care about: net flows or gross flows?
 - The abstract suggests that policymakers care about flows because of their effects on the exchange rate, macroeconomic and financial stability, and growth.
 - De Gregorio (2012) has argued that financial stability is a gross flows issue, whereas the exchange rate is about net flows.

Net v. Gross Flows

- Net or gross inflows? Many will focus on net inflows.
- But if you ask the question “Do different types of capital flows respond to the same fundamentals...”, seems to me you are in the realm of gross flows.
 - Net inflows consist of distinct components: inflows and outflows from foreigners, and inflows and outflows from domestic investors. When focusing on net inflows one never knows who, foreigners or locals, is behind the flows.
 - *If a goal is to advise policymakers, who presumably might respond to the flows, we should probably know their source.*

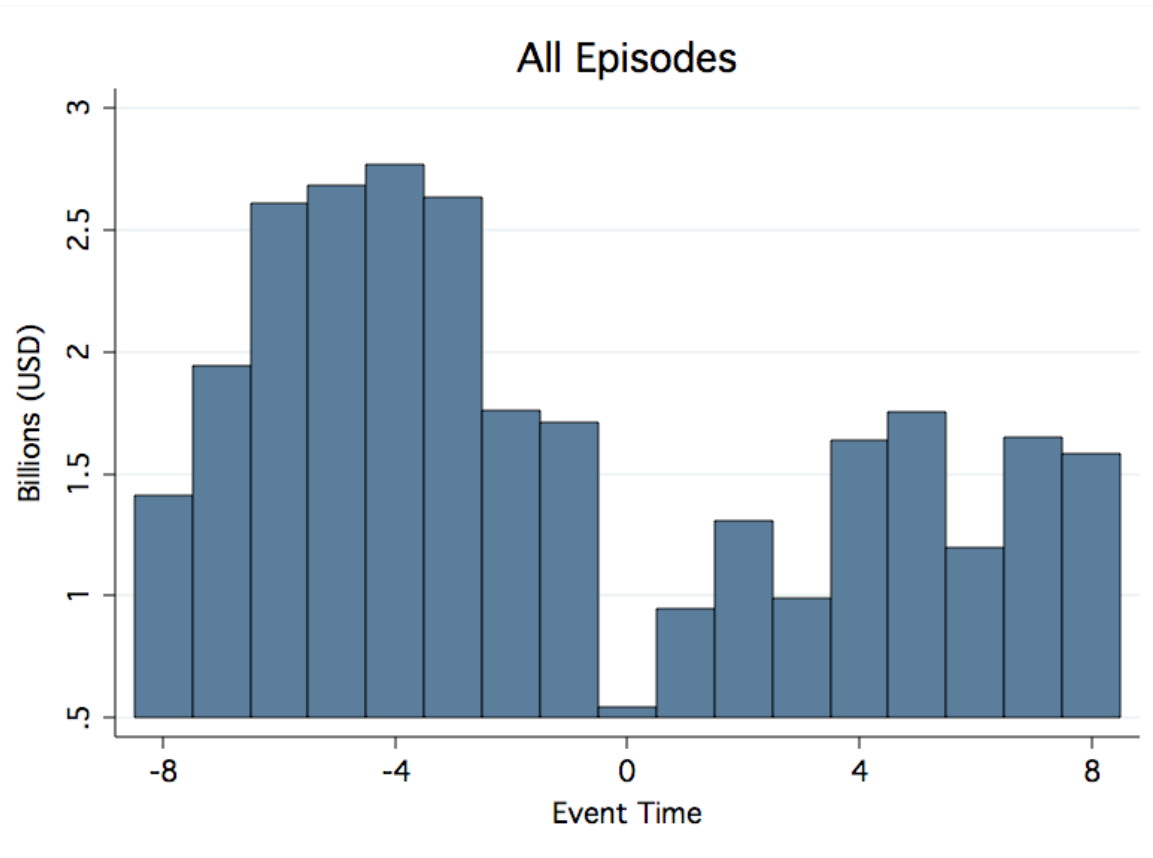
When focusing on net inflows one never knows who, foreigners or locals, is behind the flows. This matters for the policy response.

- Example: A Surge in Net Capital Inflows
 - If assume that foreigners are behind the surge, the policymaker might conclude that a tax on inflows is the right response. But perhaps the surge owed locals, knowing that prospects in the local economy are good, repatriating funds or shipping fewer funds to foreign markets? Policy would be addressing something (a surge in foreign inflows) that did not exist.
- Another: Sudden Stop in Net Capital Inflows
 - Net inflows can plummet either because foreigners rapidly exit the market, as is often presumed, or because knowledgeable locals, perhaps knowing that domestic returns are about to decrease, lead the rush to the exit. If such a “sudden stop” is troublesome, policymakers may well impose capital controls on foreigners to prevent a large buildup of positions that they might later liquidate (en masse). But if the stop owed to locals’ decision to leave (capital flight?), are capital controls on foreigners really the right policy? Or should the conditions that prompted locals to flee be addressed?

Net v Gross Sudden Stops are fundamentally different

In “net inflow sudden stops”, gross inflows pause and then resume rather quickly.

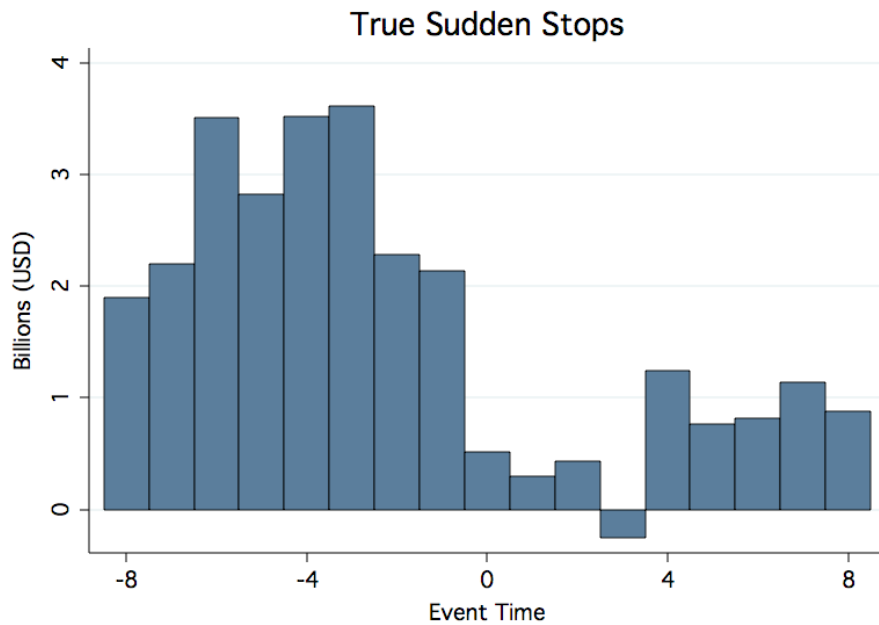
Gross Inflows in 47 net inflow sudden stop episodes



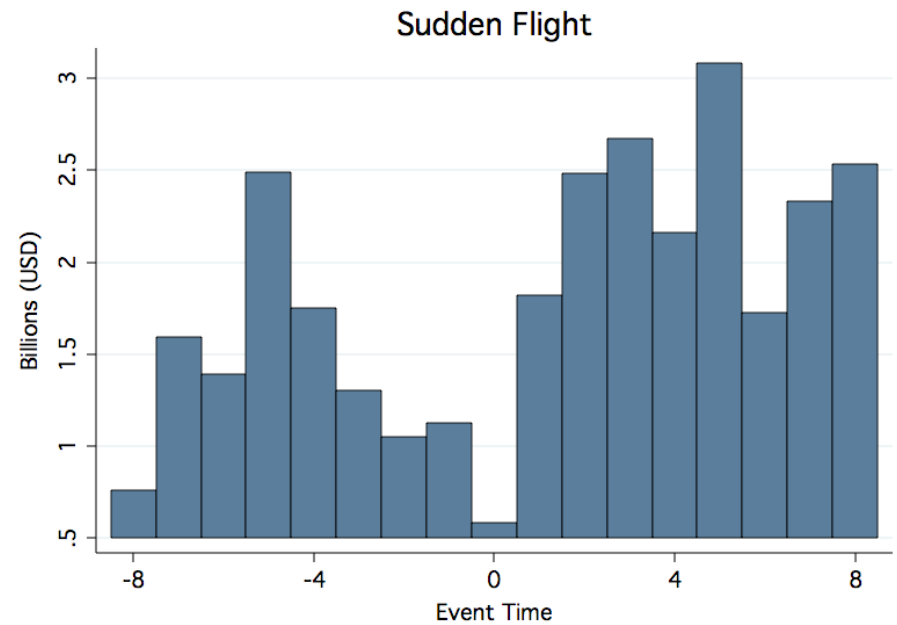
Rothenberg and Warnock (2011 *Review of International Economics*)

But net inflow sudden stops mix two very different types of episodes.

Gross Inflows in Gross Flow Sudden Stops



Gross Inflows in Sudden Flight



Many “net capital flow bonanzas” during the Global Fin’l Crisis; one gross flow surge (that was ending)

Surges	
Net Flows	Gross Flows
Belgium/Lux	Bolivia
Canada	
Chile	
Finland	
France	
Iceland	
Israel	
Netherlands	
Singapore	
Sweden	
Taiwan	
UK	
Venezuela	

Net v. Gross Capital Flow Episodes

- For Sudden Stops, Net and Gross provide different pictures. Which one do we care about?
- For inflows in general, which concerns us: Net or Gross?
 - Net, if worried about exchange rate movements
 - Gross, if worried about financial stability
- My take: Let's be sure that we use gross flows for gross flow issues (eg, financial stability) and net flows for net flow issues (eg, exchange rate pressure).

2b. Suggestions that would require work

- How should we think about reserve accumulation? Should reserve accumulation be endogenous?
- Should capital controls be endogenous?

Reserves Accumulation*

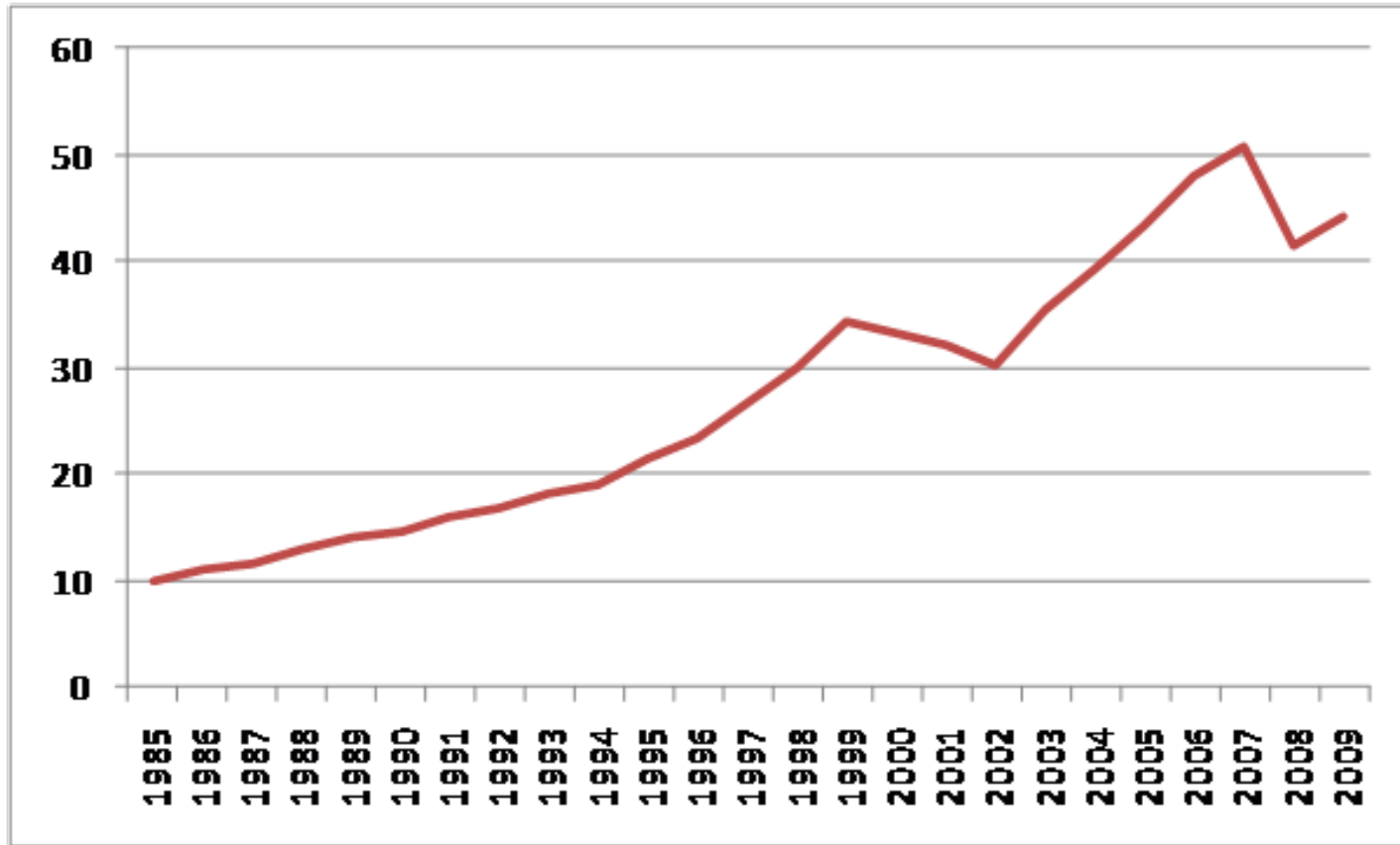
- Omitted Variable: standard push/pull approach to modeling capital flows omits a potentially important variable: Reserves Accumulation.
 - $\text{CurrAcct} = -\text{FinancialAcct} + \text{ReservesAccum}$
 - If RA has limited effect on the real exchange rate and CA, it must affect FA (which is the authors' "Total Flows").
- Endogenous: RA is likely endogenous
 - large net capital inflows may be the result of an explicit policy of reserves accumulation rather than a capital inflows *push*, or an excessive expansion of domestic expenditure that leads to a current account deficit.
 - or...large accumulation of reserves may be the policy response to massive capital inflows.

Should capital controls be endogenous?

- It's reasonable to believe that capital controls respond to capital flows and in turn might affect capital flows.
- At this stage in the literature, we need to take seriously the notion that capital controls should be modeled as an endogenous regressor.

Something Else to Ponder:

A disconnect between flow-based analysis and portfolio analysis is that financial wealth is not constant.



Trillions of US dollars.

Portfolio analysis is typically about reallocations.

Flow-based analysis comingles changes in portfolio size (wealth) and reallocations.

Recognizing this can improve analysis.

Summary

- Main takeaway: Pull and push factors still play a central role in the determination of capital flows. But factors differ across type of flow.
 - In Table 2, only financial globalization indicator and total public debt are significant and same sign for all flow types. For other variables, coefficients differ (sign, size, statistical significance) across flow type.
 - From Table 4, the GFC affected the relationship between flows and their main drivers.
- Suggestions:
 - Readily Implementable: (1) Think hard about the explanatory variables. We likely knew going in that different flows respond to different factors. What more can we learn from this? (2) Is it really net flows that you want to model?
 - Would require some work: (3) Reserve accumulation is an omitted variable, and in fact should be endogenous. (4) Capital controls should also be endogenous.



Thanks!