



Fickle capital flows and retrenchment: Evidence from bilateral banking data

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ABSTRACT

We empirically examine the response of cross-border capital flows to economic uncertainty. Using bilateral banking flow data, we show that while banks reduce their exposure to a foreign country when it becomes more risky, they tend to increase their exposure to their home country in bad times (a retrenchment). To further understand this puzzle, we examine how the differential response to foreign and domestic uncertainty is affected by country-specific characteristics, bilateral characteristics and crises. Our analysis suggests that most of the current theories, based on either information asymmetries between foreign and domestic investors or institutional risk, cannot explain bilateral data well. On the other hand, our results show that global crises have an asymmetric impact on the risk attitudes of banking institutions towards country-specific uncertainty: global crises make investors more risk-averse towards foreign uncertainty, but have no effect on the responsiveness to domestic uncertainty.

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1. Introduction

Cross-border capital flows play an important role in the business cycle. Since the 1990s both advanced and emerging market economies have experienced an increase in the magnitude and volatility of capital flows. In particular gross capital flows (purchases of domestic assets by foreign agents and purchases of foreign assets by domestic agents) have become very volatile relative to net capital flows (see for example Bruno and Shin, 2014; Broner et al., 2013). Researchers have sought to understand what drives gross cross-border flows and how they respond to (and potentially amplify) economic shocks during the business cycle (Bruno and Shin, 2014; Hnatkovska, 2010; Milesi-Ferretti and Tille, 2011; Ahmed and Zlate, 2014).

One of the key findings of the literature on gross flows is that a fall in capital inflows (a sudden stop) is usually accompanied by a reduction in capital outflows (a retrenchment). The positive correlation between outflows and inflows is especially strong during recessions (Broner et al., 2013; Davis, 2015) and has increased due to financial globalization (Davis and Van Wincoop, 2017). This positive correlation is puzzling because we expect capital to flow in the same direction irrespective of its origin. The logic of standard real business cycle models suggests that a negative productivity shock in a country will cause a fall in inflows and an increase in outflows, as agents (both domestic and foreign) reallocate capital towards other economies.

In this paper we propose a new approach to test whether capital flows respond asymmetrically to domestic and foreign shocks. We study how bilateral banking flows from country i to country j respond to uncertainty in i and j , measured by the respective stock market volatility. We focus on banking flows because, as we show below, they closely track the dynamics of

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aggregate capital flows over the business cycle. Moreover, capital flows through the international banking system are an important component of total cross-border debt flows (see [Forbes and Warnock, 2012](#); [Hélène, 2015](#); [Bruno and Shin, 2014](#); [Obstfeld, 2012](#)).¹ We find that bilateral capital flows are fickle: the capital flow from i to j falls when j 's uncertainty increases. However, bilateral flows fall also when i 's uncertainty increases (a retrenchment). In other words, while banks in country i reduce their exposure to a foreign country when it becomes more risky, they tend to increase their exposure to their home country in bad times. Our main finding is robust to the inclusion of several covariates. In particular, by controlling for interest rates, we ensure that the asymmetric response of flows to domestic and foreign uncertainty is not due to return differentials. While domestic banks increase their exposure to the domestic economy in times of greater volatility, it does not appear they are obtaining greater returns on average than what they could earn by lending to institutions in the counterparty country. Our econometric analysis provides a novel way to look at the puzzling coexistence of fickle capital flows and retrenchment. While [Davis \(2015\)](#) also studies bilateral banking flows, our paper makes two substantial contributions. First, we study the response of flows to uncertainty, rather than their correlation with output. Second, we carry out a number of tests aimed at understanding the causes of the asymmetric response to domestic and foreign shocks, as we discuss next.

The literature has provided a number of potential explanations for why sudden stops in inflows are accompanied by retrenchment of outflows. Some papers have focused on information asymmetries between domestic and foreign investors ([Tille and Wincoop, 2014](#); [Brennan and Henry Cao, 1997](#)). For example, in the model of [Tille and Wincoop \(2014\)](#) a shock to fundamentals causes agents to retrench towards domestic assets about which they have more information and are therefore more optimistic. Other papers, such as [Gourio et al. \(2016\)](#), have stressed that domestic and foreign investors face asymmetric exposure to uncertainty, due to government policies that implicitly or explicitly differentiate between foreigners and residents (such as capital controls, taxes on foreign transactions, delayed payments, partial defaults, or plain expropriation) or simply due to exchange rate risk. In the model of [Gourio et al. \(2016\)](#), foreign agents, faced with a higher probability of expropriation, sell some of their holdings of domestic assets to the domestic agents, who are immune to the risk of expropriation. More recently, [Caballero and Simsek \(2016\)](#) develop a model where investors are specialists in their local markets and can provide liquidity during a local crisis, but are fickle in foreign markets due to asymmetric information or deterioration of property rights. There is however little direct evidence on any of these theories.

We use our econometric specification to examine which factors explain the asymmetric response of investors to domestic and foreign uncertainty. First, we check if our main result holds across different types of country pairs and find that even among advanced economies domestic investors reduce their exposure to foreign uncertainty but increase their exposure to domestic uncertainty. Then, we consider a number of factors that according to the theory should play an important role in generating fickle capital flows and retrenchment. We use the distance between i and j and whether the two countries share a common official language as proxies for information asymmetries between domestic and foreign investors. We also use information on whether i and j have a common currency, in which case foreign investors face no exchange rate risk. Another possible factor affecting information frictions is the size of an economy, as information about larger economies is probably less costly to acquire. To proxy for expropriation risk, we use three indicators from the International Country Risk Guide. We then estimate whether these factors make capital flows more or less fickle. We find that capital flows are more fickle between countries that are closer to each other, contrary to theories based on asymmetric information. Similarly, capital flows are more fickle between countries with a common language or a common currency. We also find that the reaction of capital flows to foreign uncertainty is not affected by the institutional risk in the counterparty country. Finally, we find that capital flows to larger countries are less fickle and this is the only result that seems consistent with information-based theories of fickle capital (although it is clearly based on a very indirect measure of information).

While our analysis suggests that most of the current theories, based on either information asymmetries between foreign and domestic investors or institutional risk, cannot explain bilateral data well, we find that financial crises play an important role. A number of recent papers have studied the response of cross-border capital flows to global crises, see for example [Broner et al. \(2013\)](#). There is however little evidence on whether crisis episodes affect the differential response of flows to domestic and foreign shocks. In this paper we examine how global crises affect the response of bilateral banking flows to uncertainty in the reporting country and in the counterparty country. We find that banking flows are more fickle during the global crisis periods. On the other hand, our results suggest that during global crises banks are less responsive to domestic uncertainty. This implies that global crises affect the response of flows to domestic and foreign uncertainty differently.

The last two sections of this paper provide a battery of robustness and sensitivity tests. First, we address the potential selection bias arising from our unbalanced panel. We show that this is not a concern in our data using both a sub-sample for which we can construct a balanced panel and econometric techniques that weight observations by their likelihood of being censored. Second, we take into account the fact that banking flows have experienced a higher growth rate since 2000. We thus estimate a model that allows for a structural break in the relationship between flows and volatilities occurring in 2000. We find that the asymmetric response of capital flows to domestic vs. foreign uncertainty is robust to a potential structural break in 2000, although flows seem to be more fickle after 2000. Then we show that our main results are robust to different modeling choices of standard errors, various normalizations of capital flows, the consideration of return differentials and risks stemming from interbank lending market, and the exclusion of offshore financial centers. Finally we repeat

¹ For example, using data from BIS Locational Banking Statistics, [Bruno and Shin \(2014\)](#) show that cross-border liabilities of bank-to-bank are the largest (roughly 30%) among all types of creditors and debtors. At the peak in 2007, bank-to-bank cross-border liabilities accounted for 20% of total private credit and for over 30% of GDP.

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