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Global financial shocks and foreign asset repatriation: Do local investors play a stabilizing role?

Gustavo Adler [a,*], Marie-Louise Djigbenou [b,c], Sebastian Sosa [a]

[a] International Monetary Fund, 700 19th St. N.W., Washington, DC 20041, USA
[b] Banque de France, France
[c] University of Bordeaux, France

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We study the dynamic response of gross capital flows in emerging market economies to different global financial shocks, using a panel vector-autoregressive (PVAR) approach. Our focus lies primarily on the potentially stabilizing role played by domestic investors in offsetting the response of foreign investors to adverse global shocks. We find that, while foreign investors tend to retrench from emerging markets in response to global risk aversion and monetary policy shocks, foreign asset repatriation by resident investors does not always follow suit. Local investors play a meaningful stabilizing role in the face of global risk aversion shocks, with sizeable asset repatriation largely offsetting the retrenchment of non-residents. In contrast, foreign investor retrenchment in response to global monetary policy shocks is not mirrored by asset repatriation. Finally, we find robust evidence that positive global real shocks tend to have a positive impact on net capital inflows to emerging markets. Our results shed light on the likely impact of the Fed's QE tapering on capital flows to emerging market economies.

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* Corresponding author. Tel.: +1 202 623 5648.
E-mail addresses: gadler@imf.org (G. Adler), ssosa@imf.org ((S. Sosa).

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1. Introduction

Global financial markets have been a source of sizeable shocks over the last decade, with broad repercussions across the emerging market world. The crisis triggered by the bankruptcy of Lehman Brothers in 2008, and the quantitative easing (QE) programs in advanced economies in the aftermath of that crisis, are stark examples. And looking forward, new shocks are likely to occur, as the reduction in the scale of bond purchases by the U.S. Federal Reserve—i.e., "QE tapering"—marks only the start of the normalization of U.S. monetary conditions, while other advanced economies' central banks move in the opposite direction. Against this background, understanding the implications of global financial shocks in terms of their effect on capital flows to and from emerging market economies (EMEs) remains a key issue.

EMEs have become increasingly financially integrated with the rest of the world in the last two decades, raising their exposure to global financial shocks (i.e., shocks in core financial markets). However, a key feature of higher financial integration has been that both sides of EMEs' balance sheets—that is, foreign liabilities as well as foreign asset holdings—have increased. As a result, emerging markets have had at their disposal increasing resources to offset balance of payment pressures arising during episodes of retrenchment of foreign investors, often occurring at times of financial distress in global markets. Larger stocks of public sector foreign assets (primarily international reserves) are undoubtedly a source of resilience for these economies. But whether private foreign assets holdings are also a source of international liquidity, and the extent to which local investors play a stabilizing role following negative external shocks, remain open questions. Understanding the behavior of gross capital flows is, thus, critical, especially at the current juncture characterized by looming financial risks—including those stemming from uncertainty about the pace of U.S. monetary tightening.

A number of global financial shocks have taken place over the last two decades—some of them of sizeable magnitude—which are useful to assess the dynamics of gross capital flows to EMEs. These include global risk aversion shocks (also referred to as risk on/off shocks by the recent literature), as captured by the Chicago Board Options Exchange Market Volatility Index (VIX), sharp movements in the U.S. monetary policy interest rates (the Federal Funds rate), as well as movements in the U.S. long-term interest rates (e.g., the 10-year Treasury bond rate). Fig. 1 illustrates the frequency and magnitude of these global financial factors.

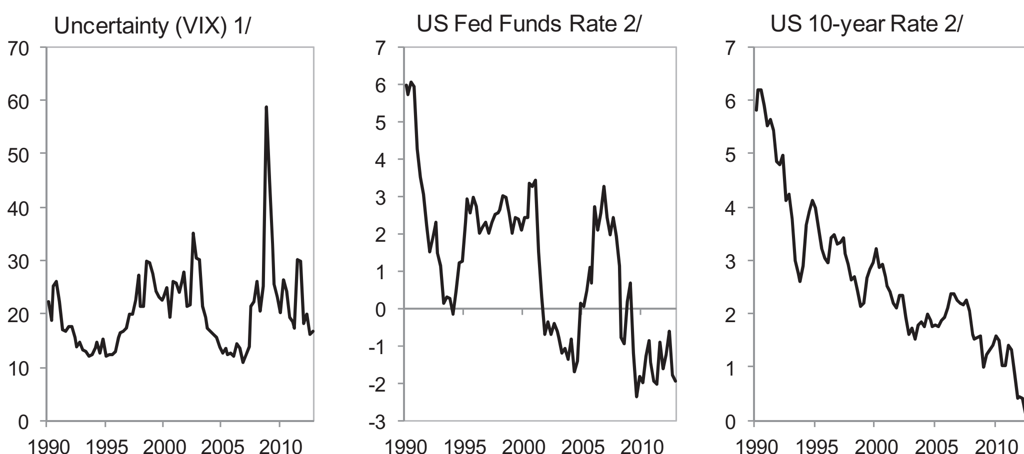

Fig. 1. Key global financial factors, in percent unless otherwise stated, 1990–2012. Sources: Haver Analytics and Cleveland Federal Reserve. 1/Chicago Board Options Exchange Market Volatility Index. 2/Real interest rates based on forward-looking (1- and 10-year) inflation expectations.

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