

Discussion, Session 1

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Monetary Policy Options for Small Open Economies

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The phenomenon of large and volatile capital flows, nature, drivers:

- Goldberg and Krogstrup: International capital flow pressures.
- Ahmed, Curcuru, Warnock and Zlate: Decomposing international capital flows.

How do small open economies best respond to disruptive flows:

- Miao: On fear of floating and gradual transitions.
- Lee, Kim and Kang: Exchange rate flexibility and economic growth.

- 1 Overview and comments on Ahmed et al
- 2 Overview and comments on Lee et al
- 3 Concluding: Broad themes and unanswered questions

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- Authors propose new empirical decomposition of capital flows:
 - Active component: flows due to active reallocation of portfolio shares among host countries.
 - Passive component: flows due to portfolio growth (higher financial wealth) or valuation effects.
- Decompositions illustrate different components behave differently. Potentially interesting new light on drivers of flows.
- Puzzling findings for correlations of VIX and QE with passive components raise questions about interpretation.

How to interpret passive portfolio growth flows?

- VIX found to drive portfolio growth flows. But VIX increases home bias and risk-off. How to understand?
- Perhaps shifts between asset classes mask active reallocations as portfolio growth.
- EM and US equities sell off, investors shift into Treasuries.
 - Negative portfolio growth as size of US equity portfolio falls.
 - Possible change in relative weights due to valuation effects.
 - Normalized weights remain unchanged (seemingly no active reallocation, but this would be false).

Are valuation-induced reallocations always passive?

- Capital flow pressures can have strong relative price effects that reduce actual flows.
- Example: An incipient inflow causes appreciation that dampens incentives for further flows. The resulting valuation effect is classified as passive.
- In a pegging country, no appreciation but official interventions and possibly larger inflows as a result. Classified as active, but the origin of the pressure is the same.

More on the VIX and missing reallocation flows

- The VIX is assumed to affect EM country flows uniformly in econometric specification.
- Goldberg Krogstrup show that VIX correlations differ across countries and over time. Not captured in panel regression.
- Would be interesting to allow for country specific correlations (or interaction with a dummy for $GRR_t^i > 0$).

- Did QE cause a "monetary tsunami"?
- Ahmed et al. find QE did not trigger active reallocation toward EMs, but rather affected valuation and portfolio growth.
- What does this mean? Did QE cause an increase in financial wealth that spilled over into passive flows? Implications for the effectiveness of QE.
- Concern: QE measure is at odds with literature:
 - Stock vs flow effects;
 - Announcement with implementation effects;
 - Forward looking markets.

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- With high current account imbalances and high financial integration, does it make sense for emerging markets to allow more exchange rate flexibility?
- The authors are sceptical, they argue:
 - EMs have lost monetary policy independence in the past decade, reducing benefits from flexible exchange rates.
 - Exchange rates play small role in CA adjustment (global value chains).
 - Panel regression analysis suggests ER flexibility is bad for growth in financially less open economies.

Is monetary policy autonomy lost?

- The collapsed Trilemma: With financial openness, monetary authorities cannot move domestic interest rates independently of foreign rates, even with ER flexibility (Lee et al, Rey, 2015).

$$dR_t^i = \beta_1 dR_t^* + \beta_2 \text{peg}_t^i dR_t^* + \beta_3 K_t^i dR_t^* + \beta_4 K_t^i \text{peg}_t^i dR_t^* + \mu^i + \epsilon_t^i$$

- Autonomy: $\beta_1 + \beta_3 \ll 1$ and $\beta_2 + \beta_4 > 1$
- Lost autonomy: $\beta_1 + \beta_3 = 1$ and $\beta_2 + \beta_4 = 0$
- Empirical literature finds that ER flexibility preserves autonomy (Aizenmann et al 2015, Obstfeld 2015, Klein Shambaugh 2013, Goldberg 2013 and others).

Is monetary policy autonomy lost?

Has autonomy declined in the past decade specifically (Lee et al)?

Table: Trilemma Regressions Before and After The Financial Crisis

| | All Countries | | Emerging Markets | | Advanced Econs | |
|------------------|---------------|----------------|------------------|----------------|----------------|----------------|
| | Pre | Post | Pre | Post | Pre | Post |
| dR^* | 0.34** | 0.35*** | 0.29* | 0.38*** | 0.56*** | 0.40*** |
| $peg * dR^*$ | -0.25 | -0.26 | -0.27 | -0.30 | 0.40*** | 0.34*** |
| $K * dR^*$ | 0.04 | 0.04** | -0.07 | 0.02 | | |
| $K * peg * dR^*$ | 0.30** | 0.22*** | 0.34*** | 0.19* | | |
| $dlog(VIX)$ | 0.13** | -0.01 | 0.35*** | -0.03 | -0.04** | -0.04 |
| R2 | 0.05 | 0.07 | 0.02 | 0.06 | 0.63 | 0.08 |
| No Obs | 4157 | 3231 | 1781 | 1427 | 2376 | 1804 |
| No Cross | 43 | 42 | 21 | 20 | 22 | 22 |

Dependent variable: Change in domestic long-term yield. R^* = Long term yield in monetary base country.

peg = Shambaugh dummy for pegged ER regimes. K = Chinn-Ito capital account openness index. Fixed effects, robust standard errors. ***/**/* : significant at 1%/5%/10% based robust standard errors.

Pre Sample runs from Jan 2000-Dec 2008, Post Sample runs from March 2009-Dec 2015.

Data Sources: IFS, Shambaugh (2004) and Chinn and Ito (2006).

Trade-offs change with financial integration

- If monetary policy autonomy is not lost, what is the problem?
The trade-offs change with financial integration.
- Exchange rate variation can become more disruptive with greater integration and stronger flows:
- Greater integration can be associated with increased currency mismatch, financial stability concerns, disruptive wealth effects, and income distribution.
- In addition, more shocks to domestic monetary conditions results in more volatility - monetary policy operates under uncertainty, lags.

Trade-offs change with financial integration

- Changing trade-offs change the pros and cons of flexible exchange rates, as well as alternative policies.
- No one-size-fits-all policy response. Many factors matter:
- Size/structure of foreign assets, structure of domestic financial system, trade, political econ of reform (Miao).
- ZLB: Major factors determining the response to capital flow volatility is recent years in advanced SOEs, but not in EMs. Advanced countries closer to the lower bound. (Svenson's (2003) foolproof way.

Empirical findings: Interpretation and causality

- The paper's central finding: exchange rate flexibility reduces growth when financial openness is low. Raises questions.
- By what mechanism would low openness reduce the benefits to exchange rate flexibility?
- Interpretation is ambiguous. Financial openness and ER regime are both policy variables, and interdependent.
 - Alternative interpretation: Given exchange rate regime, what is the effect of financial openness on growth?
- Endogeneity and causality issues (ER regime endogenous, openness proxies income level, etc)

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Broad themes and unanswered questions

- Capital flows have been virulent and disruptive. Understanding remains partial. Ahmed et al is a promising contribution, confirms role of a global financial cycle and monetary policy.
- Much variation remains unexplained. Future research to address the role of changes in financial market structure.
- Small open economies' policy options remain well described by the Trilemma - but trade-offs may have changed. Miao and Lee et al contributions suggest no one-size-fits-all policy.