"International Investors in Local Bond Markets"

Some Comments

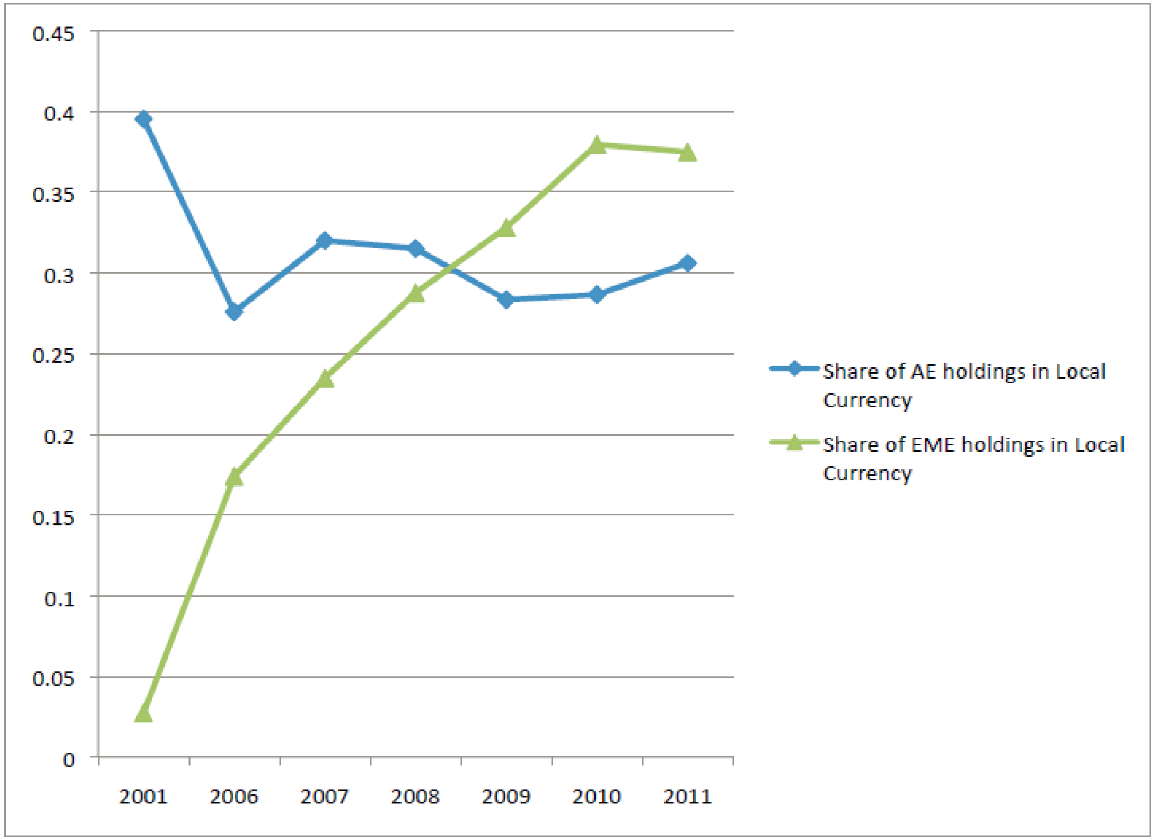
Josh Felman
IMF Research Department*

***Disclaimer: views are personal!**

EM's: The End of "Original Sin"

Figure 2. Share of US Holdings of AE and EME Bonds denominated in local currency

The figure shows, for US investors' foreign bond holdings as of year ends 2001 and 2006-11, the shares of AE and EME holdings that are denominated in the local currency.



Good news … or bad?

- Beneficial: lowers domestic cost of capital, reduces currency mismatches, allowing greater exchange rate flexibility

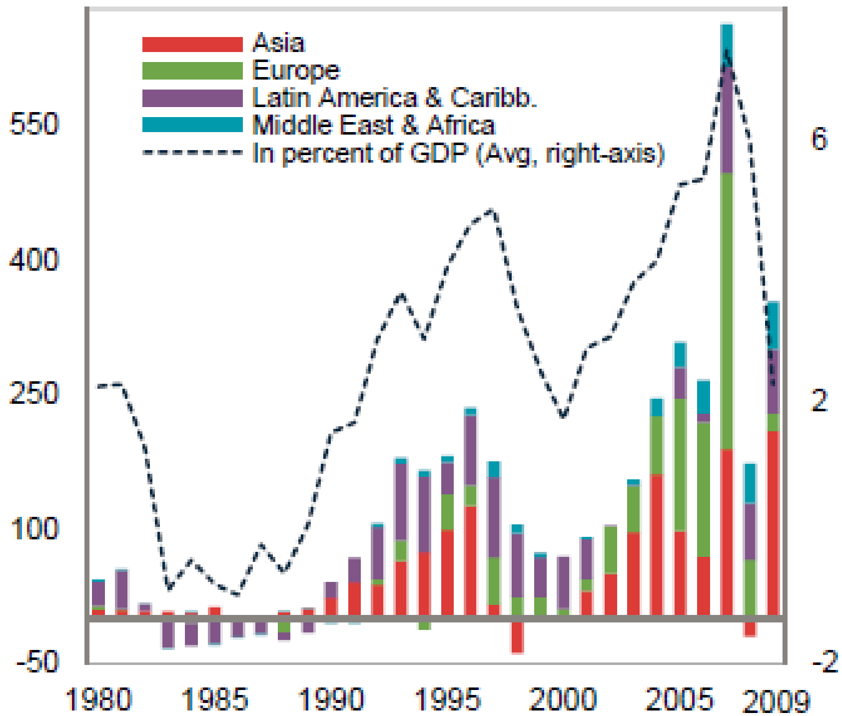
- Costly: capital comes in waves, overwhelming and destabilizing EM's

Policy implications

- Beneficial: open up capital account, so as to spur growth
- Costly: regulate flows to preserve financial stability
- So, it's important to settle this controversy

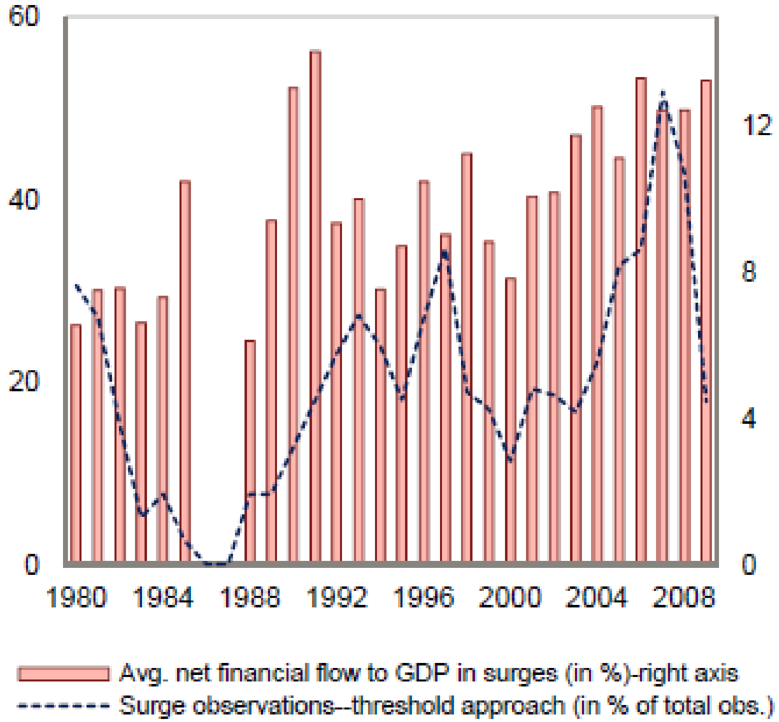
Evidence: Tidal waves…?

Figure 1. Net Capital Flows to EMEs, 1980-2009 (in USD billions)



Or Targeted Flows?

Figure 2. Surges of Net Capital Flows to EMEs, 1980-2009



Source: Authors' estimates based on IFS.

Paper: Overview

- Important controversy
- Paper brings new evidence to bear
  - Looks at the actual behavior of investors, pre- and post-GFC
  - Examines what influences their allocations
- Carefully investigated
- Nicely written up

Paper: Findings

- Allocations depend on “push” *and* “pull” factors
- Key global push factor
  - Expansionary monetary policy in the US
- Key country-specific pull factors:
  - Current account balances
  - Inflation volatility

Paper: Implications

- Some truth on both sides
  - Beneficial: Country fundamentals are important
  - Costly: QE launched a wave of capital to EM's
- Sounds like a fair and balanced assessment
- Are we done?
- Not at all!

Back to Theory

- Let’s rethink issue from first principles
- Purpose of inflows is to allocate global capital
- For efficiency:
  - Capital should flow to country with highest relative rate of return
  - Country with inflows should have current account *deficit*
- Worry if:
  - Capital is allocated inefficiently
  - Or if there are externalities, which undermine competitiveness or stability
- Does paper shed light on these issues?
- No…and yes!

Two Frameworks

- Paper
  - Framework: inflows = f(push, pull)
  - Bad = push
- Theory
  - Framework: inflows = f(return, risk)
  - Bad = inefficiency, externality
- Are these two the same?
- Not at all!

Frameworks: Key Differences

- Frameworks
  - Theory: inflows = f(return, risk)
  - Paper : inflows = f(push, pull)

- Efficiency
  - Note that in theory inflows depend on *relative* returns, i.e. both r and r*
  - So, push can be efficient!

- Externality
  - "Excessive" inflows can trigger credit booms or exchange rate overvaluation
  - But this can happen even if inflows are "pulled" by attractive conditions in EM

- Bottom line: push is not necessarily bad, pull not necessarily good!

The Findings, Again

- So, let's re-examine the findings, using new framework
- Look for evidence of inefficiency or externality

Externality

- Are inflows excessive?

- Some macro evidence:
  - Inflows were high pre- and post-crisis
  - Which fed credit booms in EMs
  - That have now turned into busts

- Paper sheds no new light on this

Efficiency

- What about efficiency?
- Here, paper does have something new to say
- Something rather startling!

Efficiency Problem: Flows Are Insufficient!

	2011				2008		2006		2001	
	US Holdings ($ B)	ω_{us}	ω_m	ω_{us}/ω_m	US Holdings ($ B)	ω_{us}/ω_m	US Holdings ($ B)	ω_{us}/ω_m	US Holdings ($ B)	ω_{us}/ω_m
EM	**86.89**	**0.37**	**6.80**	**0.05**	**28.39**	**0.03**	**20.11**	**0.03**	**1.72**	**0.00**
Asia	**19.76**	**0.08**	**4.67**	**0.02**	**5.17**	**0.01**	**2.77**	**0.01**	**0.06**	**0.00**
China	0.31	0.00	3.42	0.00	0.20	0.00	0.01	0.00	0.00	0.00
India	0.34	0.00	0.57	0.00	0.01	0.00	0.00	0.00	0.00	0.00
Indonesia	5.83	0.02	0.10	0.25	1.85	0.12	1.08	0.06	0.00	0.00
Malaysia	7.73	0.03	0.27	0.12	2.59	0.06	1.06	0.04	0.02	0.00
Pakistan	0.00	0.00	0.04	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Philippines	3.97	0.02	0.07	0.23	0.05	0.00	0.04	0.00	0.01	0.00
Thailand	1.58	0.01	0.20	0.03	0.48	0.02	0.57	0.02	0.03	0.00
Other EMs										
South Africa	7.34	0.03	0.19	0.16	0.91	0.04	1.04	0.03	0.44	0.03

1: Insensitivity to Returns?

- Foreign returns matter
  - Perhaps coefficient too low?
  - Can't say, because no benchmark is calculated
- Paper finds expected domestic returns (r) don't matter
  - Mismeasurement? Possible, but great effort is made to carefully estimate r
  - Worrisome!

2: Capital Controls?

- Paper finds controls don’t matter
- Seems odd
- In India, at least, limits on foreign participation in bond market seem effective
- Perhaps a measurement issue?

3: Risk Averse Investors?

- Paper finds flows are related to risk
  - Current account balance
  - Inflation volatility
- But excessively? Again, no benchmark

- More fundamentally: Are these the right measures of risk?
- More standard measures:
  - Reserves
  - Debt
  - Credit booms
  - Overvaluation

Bottom line

- This is a remarkable paper
  - Masquerades as conventional
  - But actually very provocative

- Takes a critical controversy, with important policy implications

- Raises important questions
  - Are inflows excessive… or insufficient?
  - How can we tell?
  - What could explain this?

- My recommendation
  - Read it -- soon
  - Consider its implications
  - And start your research

- As they say in F1 racing:
- Gentlemen, ladies, start your engines!

THANK YOU