Comments on

CAPITAL FLOW WAVES:

SURGES, STOPS, FLIGHT, AND RETRENCHMENT

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Key points

- Develop a new methodology for identifying episodes of extreme capital flow movements using data that differentiates activity by foreigners and domestics.
- Identify episodes of

- "surges" and "stops" (sharp increases and decreases, respectively, of gross inflows), driven by foreigners;

-- "flight" and "retrenchment" (sharp increases and decreases, respectively, of gross outflows), driven by domestic investors.

- Global factors, especially global risk, are significantly associated with extreme capital flow episodes.
- Contagion [through trade, banking, or geography] is associated with stop and retrenchment episodes.

Results, cont.

- Domestic macroeconomic characteristics are generally less important.
- Found little association between capital controls and the probability of having surges or stops driven by foreign capital flows.
- Capital controls are not significantly related to the probability of having surge, stop, or retrenchment episodes.
- Greater global liquidity is rarely associated with an increased probability of any type of episode.
- A country's financial system (measured by size or efficiency) does not have any significant relationship with surge, flight, or retrenchment episodes.

Overall,

- A very nice paper, a fresh approach.
- Yet, it would be even nicer once it acknowledge **the elephant in the room**.

Is there an elephant in the room?

- Why do we care about capital flow waves?

Probably, due to the association of capital flow waves with crises.

- Is the size of the waves (gross inflow and gross outflow) the key for determining the impact of a wave on the probability and the depth of crises [banking, exchange rate, sovereign debt crisis]?
- Probably not: global factors that may lead to massive crises in Korea, Island, and Greece, would induce minor impacts on Singapore, Hong Kong and China.

The impact of the waves depends on their composition, and country's initial exposure

- A key issue is the association between the composition of the waves (gross inflows and outflows), and the probability and severity of domestic crises.
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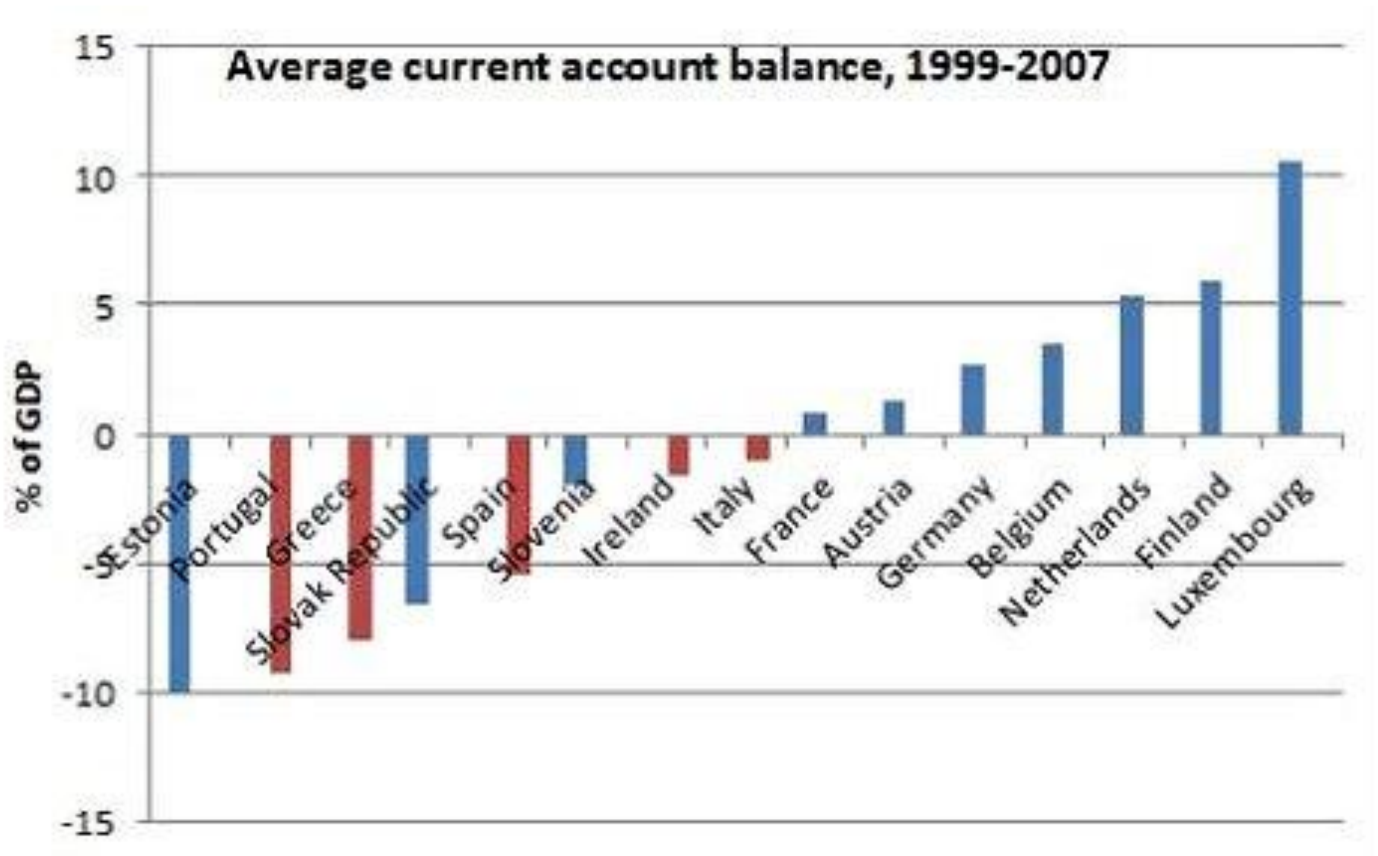
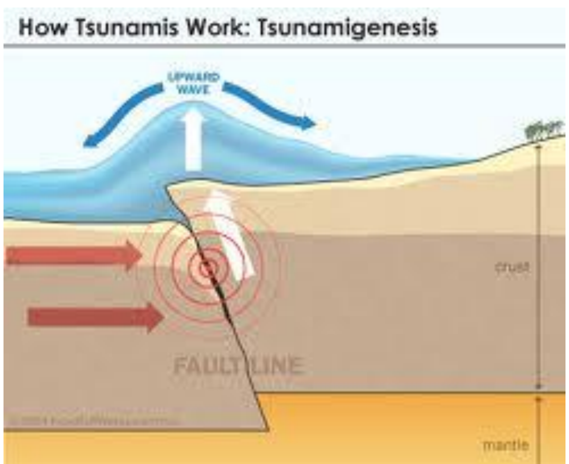
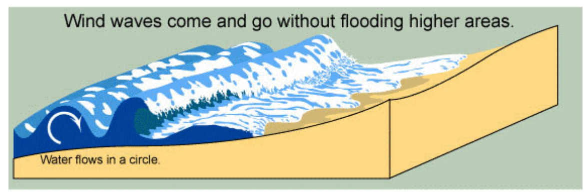
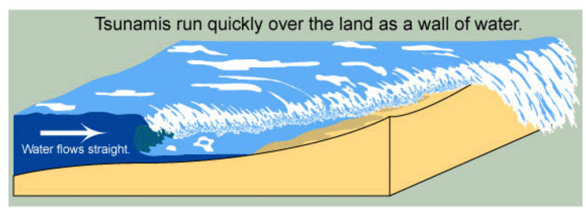


We may think about the global waves in 2008 as a financial Tsunami that started in the US.

- **Once that it hits the off shore countries, it's effect was determined by 'composition issues' explaining it's energy when it hit the shore, and local initial conditions.**
- A year ago, the Japanese Tsunami generated huge but localized damage in Japan [pays its cost until today]. Sizable damage in the SC harbor, with one fatality, no damage in SF [9 hours flying distance from Japan].







Composition of gross flows and a country's initial conditions may be of key importance in explaining the association of a given wave with exposure to crises

- By focusing on the gross inflows and outflows, the authors overlook the key importance of the composition of these gross flows.
- Chances are that, had 90% of the gross flows impacting Korea in 2008 been FDI, Korea would not have needed a swap line from the FED, and the Korean Central bank would not have engage in the bail out of its banking system.
- In fact, a lion's share of the 'Korean wave' was in the form of dollar short term debt flows.

Capital controls: composition matters

- The authors find little association between capital controls and the probability of having surges or stops driven by foreign capital flows.
- While capital controls in the form of taxes and reserve ratios may have little impact on the size of waves, they may have sizable impact on the composition, which in turn may matter for the exposure and depth of crises.
- China is not in the sample. I doubt if the authors believe that Chinese controls don't impact the waves facing China…
- While trade mis-invoicing allows costly arbitrage of some of these controls, they bite when and if the authorities would like them to bite…

1990-2006 and after

- Most of the capital controls in the 1990-2006 were mild, with limited effective enforcement.
- Yet, countries differed in terms of domestic regulations, controls and composition of their internal financial intermediation.
- The best performers during and after the 2008-9 crisis turned out to be countries with
  - conservative CBs, tight internal regulators,
  - signification de facto fiscal space [debt/tax collection],
  - (managed) flexible exchange rate,

  Including Poland, Israel, Chile, Australia, Canada.

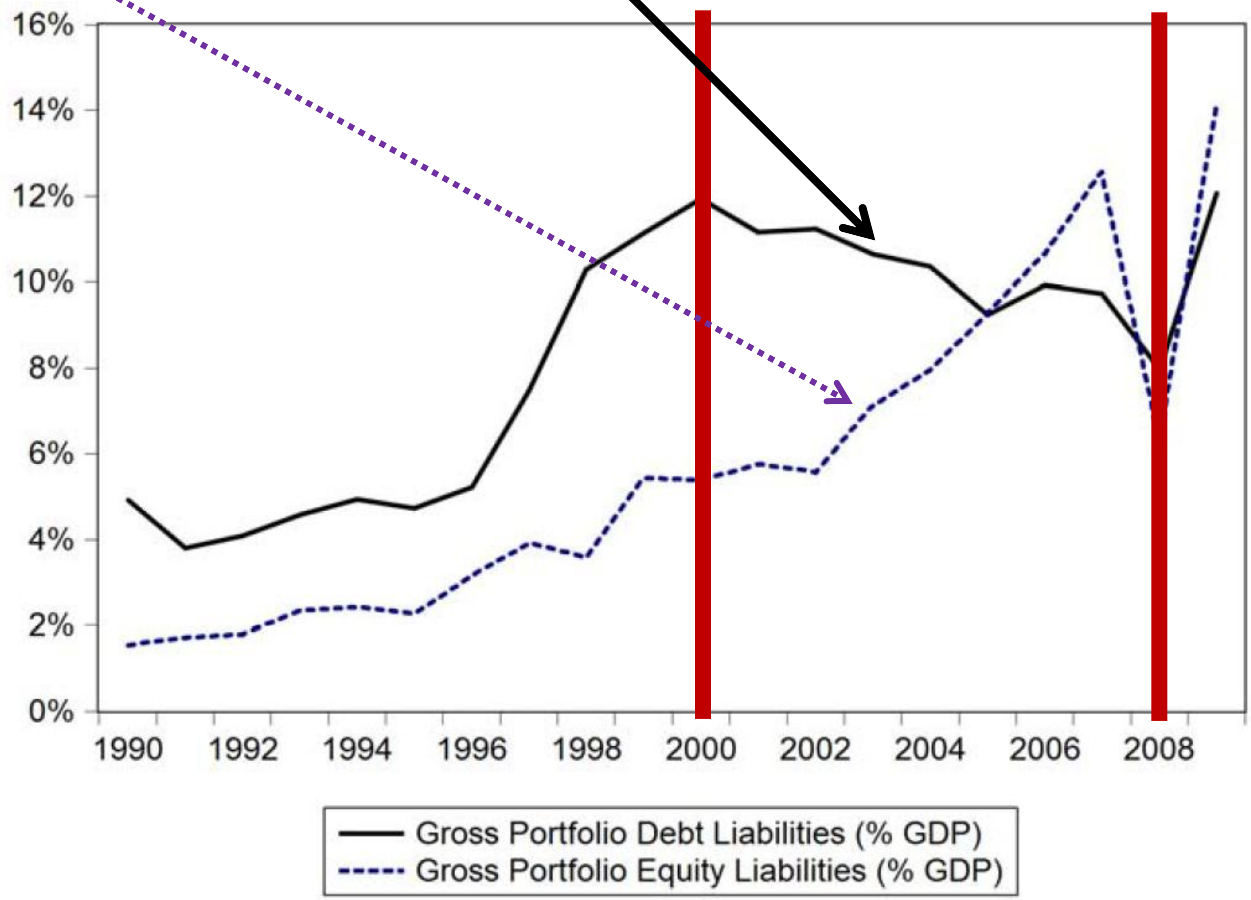
Local market conditions are the key in accounting for the costs of the 08 crisis.

A Long-Run View of Portfolio Investment External Liabilities (EMs Average),

"From the Great Moderation to the Global Crisis: EMP in the 2000s", Aizenman, Lee, Sushko. OER 2011

- 2000-2008: A gradual drop of external debt & increasing external equity positions of EMs foreign liabilities.

- EMs entered the 2008-9 crisis with a sizable IR buffer, & managed ER flexibility.
-This configuration allowed EMs a broader choice than during the financial crises of the 1990s.



Thanks for you attention