Understanding the pro-cyclicality of capital flows

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Outline of discussion

- What the paper does
- Main findings
- Some comments on the empirical part
- How it fits in the literature
- How relevant it is?
  - How does it fit in the context of India?
  - EMs in general in the current environment?

What the paper does

- Establishes cyclical patterns of capital flows in India
- Develops a model with frictions and shocks to trend growth rate
  - Credit constrained households
  - Less than perfect international financial integration

What the paper finds

- Capital inflows, gross flows, are highly pro-cyclical; net inflows less so; outflows are mildly so
- A model with frictions, and permanent income shocks can generate pro-cyclical capital flows
  - In good times, given **permanent income shocks**, household expect good times to continue, they consume more, save less, and borrow to increase the consumption, capital inflows increase to finance the current account deficit
- The interaction of international financial integration and domestic financial development can generate countercyclical capital flows.

Questions / comments on the empirical part

- Annual data from IFS? Which years?
- How many observations?
- Why not quarterly data?
- Statistical significance of the correlations?
- Does the cyclical properties vary over time?
- How do you deal with negative capital inflows and outflows?
- What about current accounts/ trade balance

Overall, much more needs to be done to convince a skeptical referee that capital flows are indeed pro-cyclical

How the paper fits in the literature? *Aguiar and Gopinath (2007)*

- Stylized facts about business cycles in EMs; how they differ from developed markets
  - strongly countercyclical trade balance in EMs
  - consumption is way more volatile than income at business cycle frequencies in EMs
  - Note: India is not in their sample of EMs.
- Shocks to trend growth primary source of fluctuations in EMs
- Standard RBC model can explain business cycle features of both EMs and developed economies

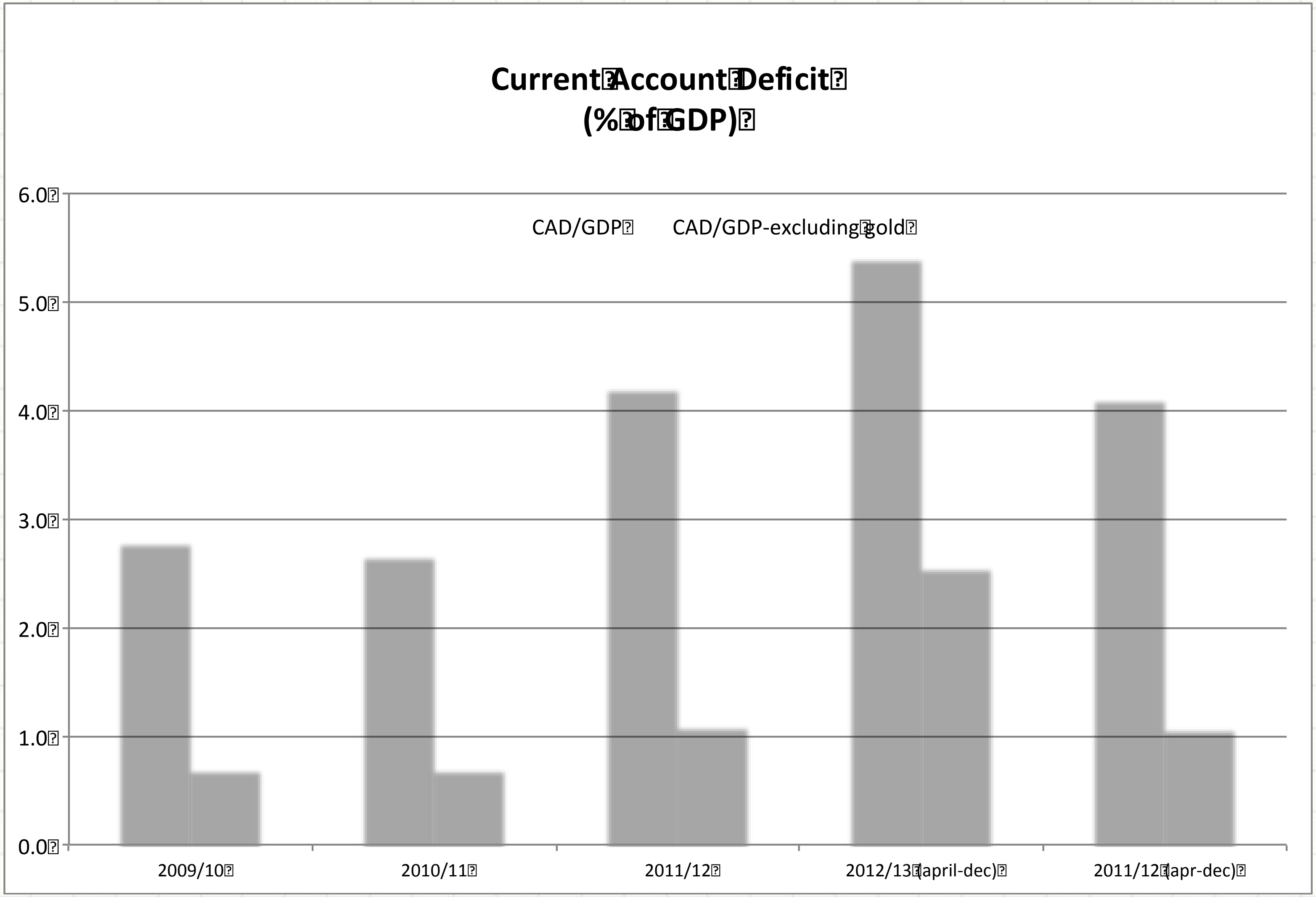
My thoughts on this paper …

- No frictions ***necessary*** to explain business cycle features of EMs
- Introducing these frictions is perhaps realistic, but not really crucial to explain the business cycle features as in AG . Therefore perhaps not really interesting
- Interaction of international financial integration and domestic financial development can generate countercyclical capital flows
  - Intuition not clear
  - No frictions: back to Aguiar and Gopinath world?

How relevant the paper is in Indian context?

- India story is: Rising CAD with slowing growth
  - Trade balance deteriorates in bad times?
  - Perhaps permanent negative shock to trend growth, but increasing trade and current account deficit?
  - How does this square with the environment in AG, and the current paper?

Considerable variation across EMs: India is different: Have of CAD is gold!



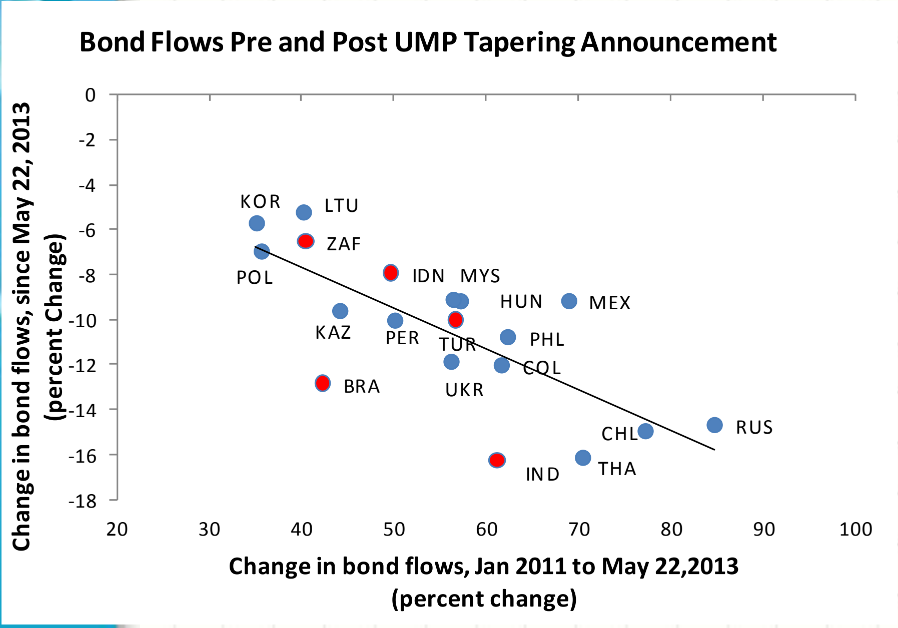
Savings have increased but in physical assets

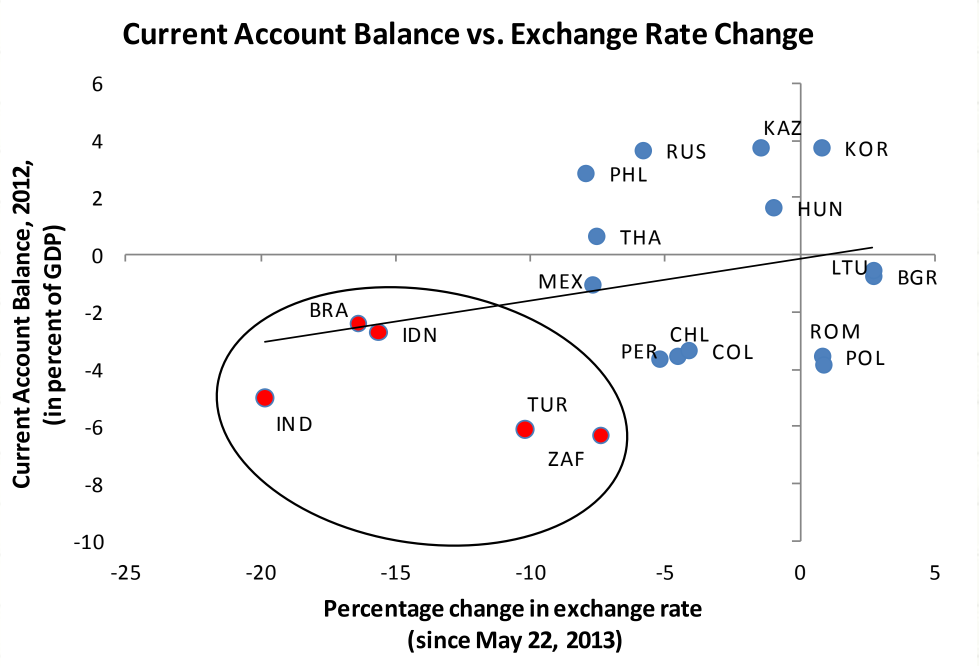
- Savings have increased in bad times; but substantially in physical assets ….
- Not financial ones
- Imports of gold: should it be treated as increasing CAD, or as a capital outflow

Recent experience of EMs in general in response to anticipation of exit from UMP …

- Capital outflows by FII … bond and equity
- It is not that domestic residents are saving more in financial assets
- Foreign investors are taking their money out ..
- How do we explain this -- ?

Most importantly, significant differences across EMs





Overall …

- Enjoyed the paper, learnt a lot
- But not convinced how significant the contribution of the paper is
- How relevant the paper is for India and in explaining the recent events

Thank you!