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Discussion of
"International Capital Flows and Domestic Financial Conditions"
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What does this paper do?

- Provide a very comprehensive and clear review of
  - the patterns of international capital flows
  - their linkages with domestic financial systems
  - and policy challenges in maintaining monetary and financial stability in the face of volatile capital flows
- A succinct summary of the state-of-the-art of the subject

What does the paper say (I)?

- The scale has trended upwards but with pronounced boom-bust cycles.

- The striking configuration of Asia's international investment position cushioned its performance during crisis.

    - The low debt-equity ratio in foreign liabilities implies a considerable risk transfer to foreign investors.

    - Similarly, the high debt-equity ratio in relation to foreign assets represents an important hedge against currency risk.

- Looking to the future, it is open to debate whether the current configuration of external financial patterns for emerging Asia will persist.

    - the overall scale to grow in line with rising levels of income per capita and the rate of domestic financial development

    - the relaxation of restrictions on capital outflows should be associated with greater outward investment activity by domestic private-sector entities across the full range of investment categories.

    - it is plausible that much of this outward expansion will be regionally focused, in view of the influence of gravity factors on international investment patterns.

What does the paper say (II)?

- The level of net capital flows is not a sufficient statistic for the international distribution of macro-financial risks.
  - necessary to inspect the detailed composition of the underlying gross flows and gross positions

- The increasing importance of foreign assets and foreign liabilities in bank balance sheets is a contributory factor to the weakening of the relation between domestic monetary aggregates and domestic credit growth.

- Even capital flows that do not directly flow through the domestic financial system have an indirect impact by influencing macroeconomic outcomes and asset price determination.

- Moreover, the central role of global factors in determining the level of capital flows adds to the complexity of maintaining domestic financial stability.

What does the paper say (III)?

- In terms of designing an appropriate policy response, there is no "one size fits all" approach.

- Governments must adapt domestic policies in recognition of the underlying structural changes, and be vigilant in implementing counter-cyclical measures to offset the impact of temporary shocks.

- Different combinations of monetary, fiscal and macro-prudential instruments are consistent with the maintenance of macro-financial stability, with a possible supplementary role for capital flow management policies under certain conditions.

Outline of comments

- The cause and desirability of the “long debt, short equity” structure of Asia’s international balance sheet

- The industrial organisation of the market in global liquidity

“Long debt, short equity”

- Cause?
  - ➢Inevitable result of emerging Asia’s higher growth rate?
  - ➢Restricted capital account, particularly in terms of private sector outflows?
- Desirability?
  - ➢This lopsided balance sheet structure may provide some cushion during crisis;
  - ➢but it is an expensive insurance policy, because in normal times it generates very low or negative net investment incomes.
  - ➢It also leads to excess liquidity in domestic financial systems.
  - ➢Chinese capital account liberalisation and renminbi internationalisation can help. (He and Luk, 2013)

Transition to a more balanced structure

US (current)

FDI and PI in Asia	Safe US Securities

Asia (current)

Safe US Securities	FDI and PI from the US

US (more desired)

FDI and PI in Asia	Safe US Securities
Safe Asian Securities	FDI and PI from Asia

Asia (more desired)

Safe US Securities	FDI and PI from the US
FDI and PI in the US	Safe Asian Securities

The industrial organisation of the market in global liquidity

- Need to move from *products* (types of flows) to *institutions* and *market structure*
  - ➢Concentration, herding and other types of destabilising behaviour (“elephant in the pond”)
  - ➢Or even market manipulation? (e.g., “double play” in Hong Kong in 1998)

- Need to expand the focus from banks to other types of players
  - ➢The evolving nature of global liquidity (Shin, 2013)
  - ➢Should asset managers and other “buy-side” investors be considered as potentially systemic investors? (OFR, 2013)

- The typology of the market
  - ➢Residence vs nationality of bond issuers
  - ➢Different configurations of sources and uses of funds in offshore markets (He and McCauley, 2012)

Implications for capital flow management policies

- Should these policies be designed so that they address failures of the market in global liquidity?

  - In comparison and in contrast to setting up "walls" and "gates"

- How do we design policies that encourage rational and responsible behaviour by *investing institutions*?

  - To minimise disruptions in markets caused by fire sales

  - To reduce exposure of creditors, counterparties, and investors

Thank you for your attention

References

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