Discussion of Mourmouras “Capital Flows…”

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Bank Negara Malaysia’s Conference
“Monetary Policy in the New Normal”
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At the outset I have to state that it wasn't clear what I should discuss.

– Which of the two papers provided, neither of which matched the title of the talk?
– Or the presentation also submitted? It matched the session title (and date). But at 56 slides seemed to have material for at least 3 papers plus policy talking points.

I'll call what I received the "packet" and will form my remarks around some aspects of it.

1. Main Takeaways

- Throughout the packet, a constant is an underlying neoclassical growth model.
  - Expect flows from AEs to the more productive EMEs to lead to rapid convergence in per capita income, but frictions get in the way to not only slow this process but (some would say) lead to EME outflows not inflows.
- In part of the packet, we're in a particular second best world in which labor is not well insured against bad shocks, so introducing another friction (a flow tax that builds reserves) can be helpful.
  - National welfare can be increased by imposing remunerated reserve requirements on inflows, acquiring buffer stocks of international reserves, and providing conditional financial support to distressed firms in a crisis.

1. Main Takeaways (cont)

- The last 30 pages of the submitted ppt lays out what happened during the crisis (with a focus on leverage) and then the non-standard policy responses (and their effectiveness, the spillovers, exit strategies, etc.)
  - I enjoyed looking through these pages, but it is not exactly clear what a discussant should say about this portion.

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2a. Thought One

- The Lucas Paradox of surprisingly little flows to EMEs – and even outflows – is mentioned a few times.

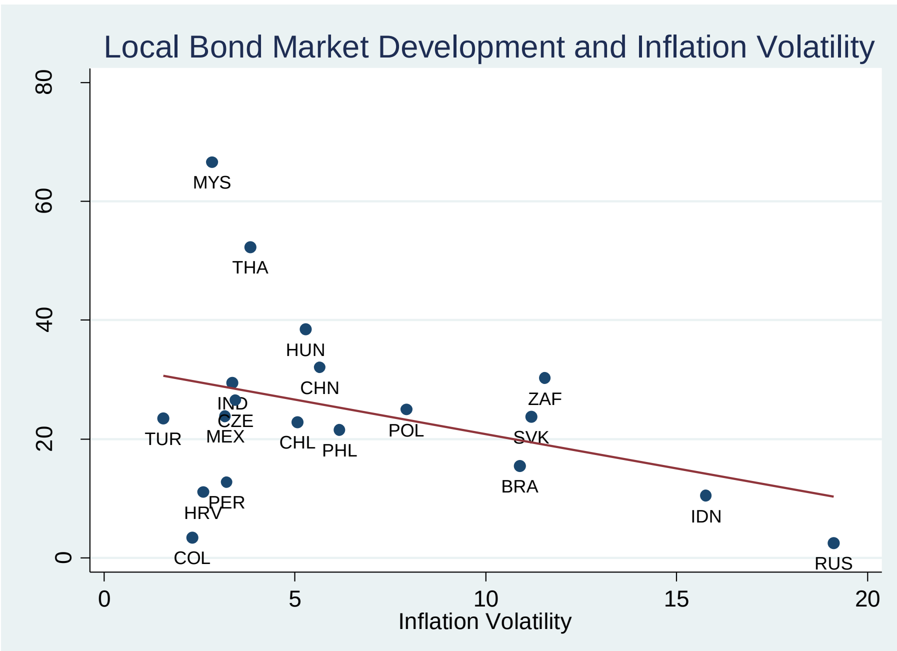
- Let’s be clear that this is a sovereign-to-sovereign issue. There is no paradox in private capital flows.
  - See Alfaro, Kalemli-Ozcan, and Volosovych (2011) "Sovereigns, Upstream Capital Flows and Global Imbalances", NBER WP17396. Or the abridged version at http://www.voxeu.org/article/upstream-sovereigns

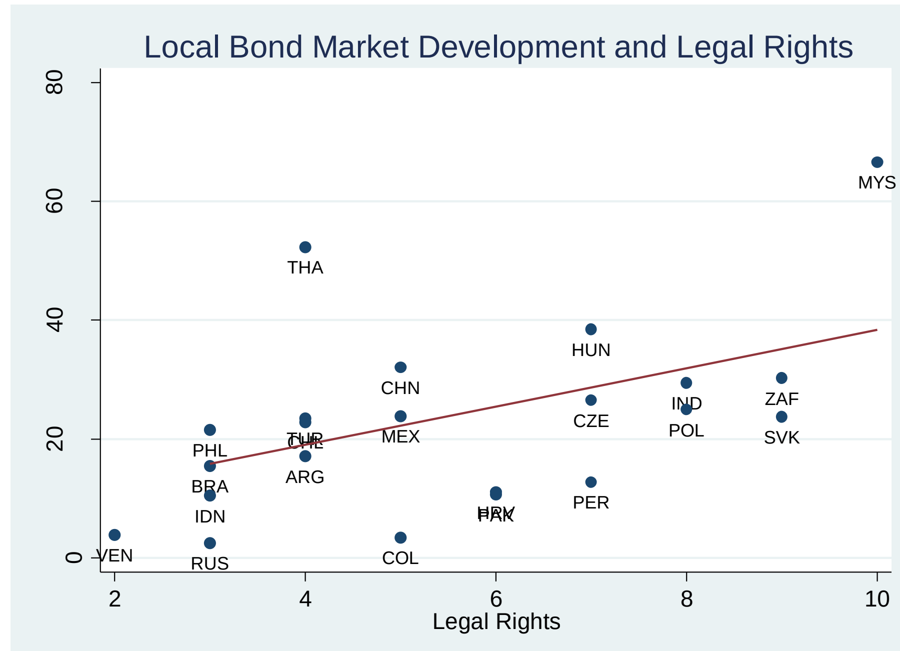
2b. Thought Two

- An important aspect of the model is that local banks obtain funding from foreigners. When the foreign funding proves fickle, to stave off defaults/liquidations it would be good to have a war chest of reserves to prop up the local firms.
  - (The war chest presumably took a decade to stock, perhaps at the expense of other reforms.)

- Another solution: Enable the development of the local bond/credit markets. Reduce the reliance on foreign funding at the outset.

For some EMEs, the assumption in the packet – that funding comes from overseas – is reasonable. But many EMEs have built impressive local currency bond markets (LCBMs), which can alleviate currency mismatches, improve financial stability, etc.





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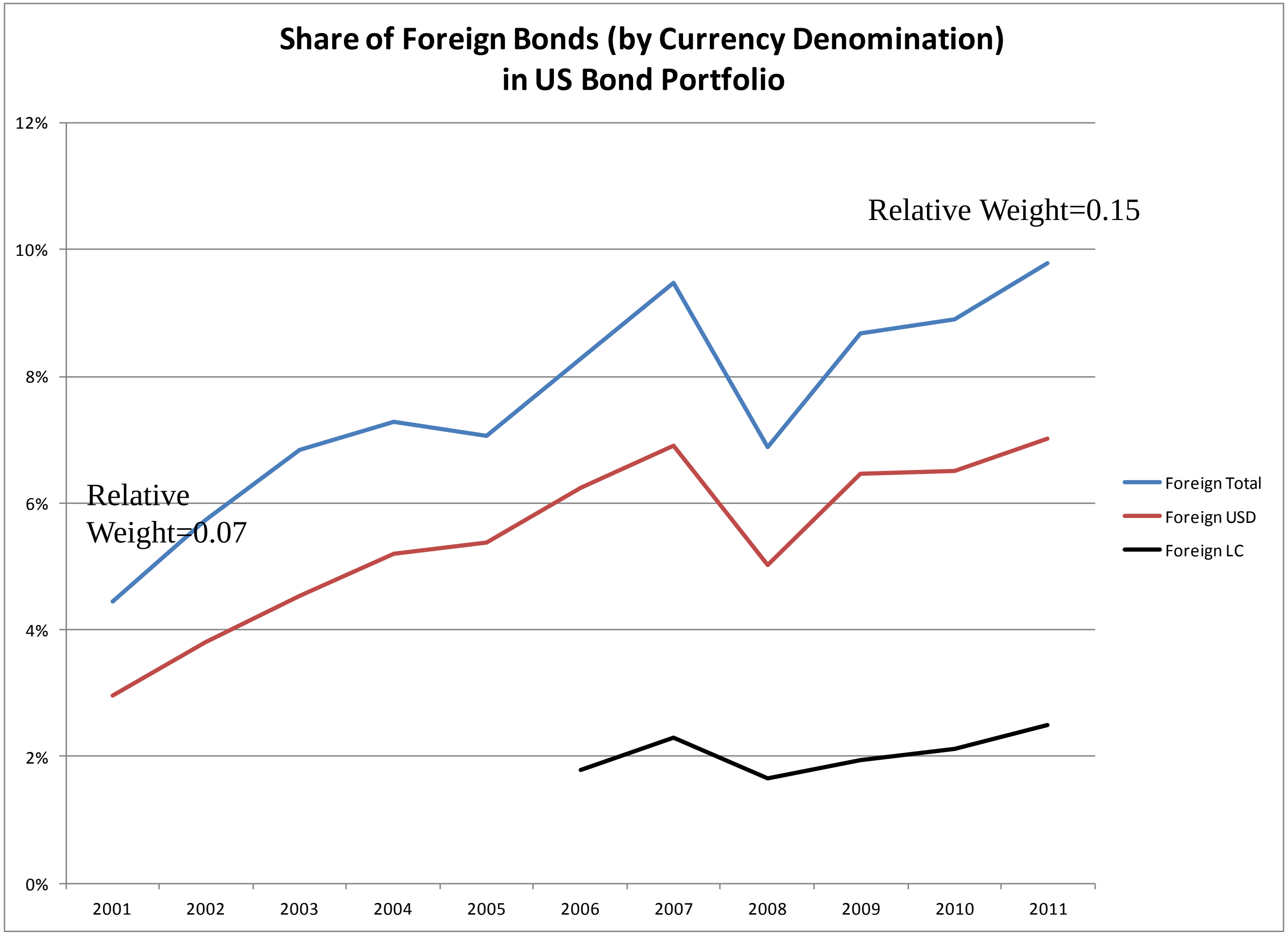
2008 data. Local currency bond markets are expressed as a percent of GDP. Source: Burger Warnock Warnock 2012 "Emerging Local Currency Bond Markets" Financial Analysts Journal.

Problem: International (US) investors prefer USD-denominated bonds. Share of USD-denom foreign bonds in US investors' bond portfolios has more than doubled over the past decade.



NonUS bonds maintained roughly the same share in the global portfolio (63%), so relative weight in US portfolios also doubled.

Note: 70+% of US foreign bond portfolio is USD-denominated.

Relative Weight is weight in US portfolio divided by weight in world portfolio.

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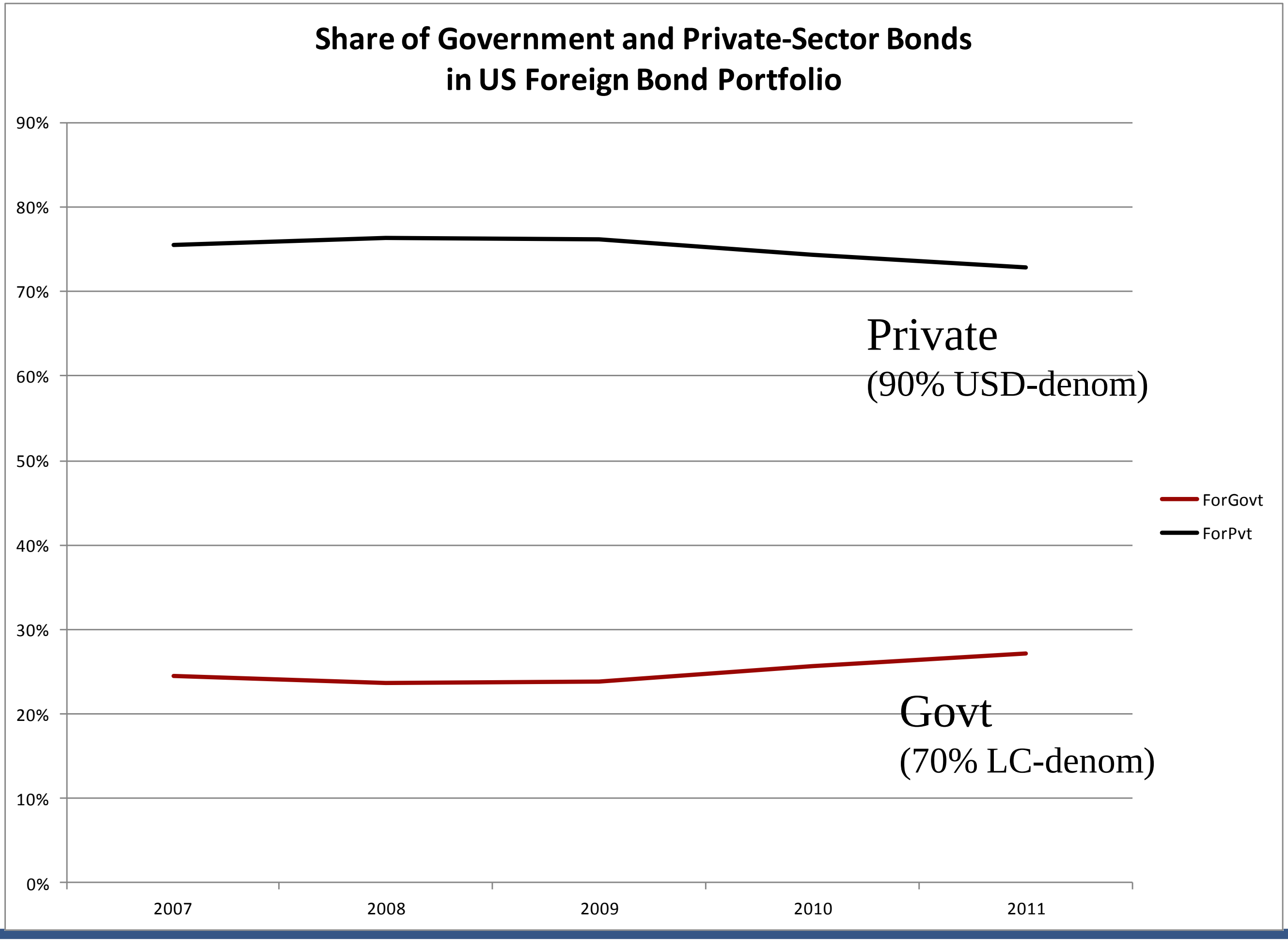
And who issues the USD-denom foreign bonds? Private sector.

Three-quarters of US foreign bond holdings are in private sector bonds (mostly USD-denominated), one-quarter in sovereign bonds (mostly local currency).



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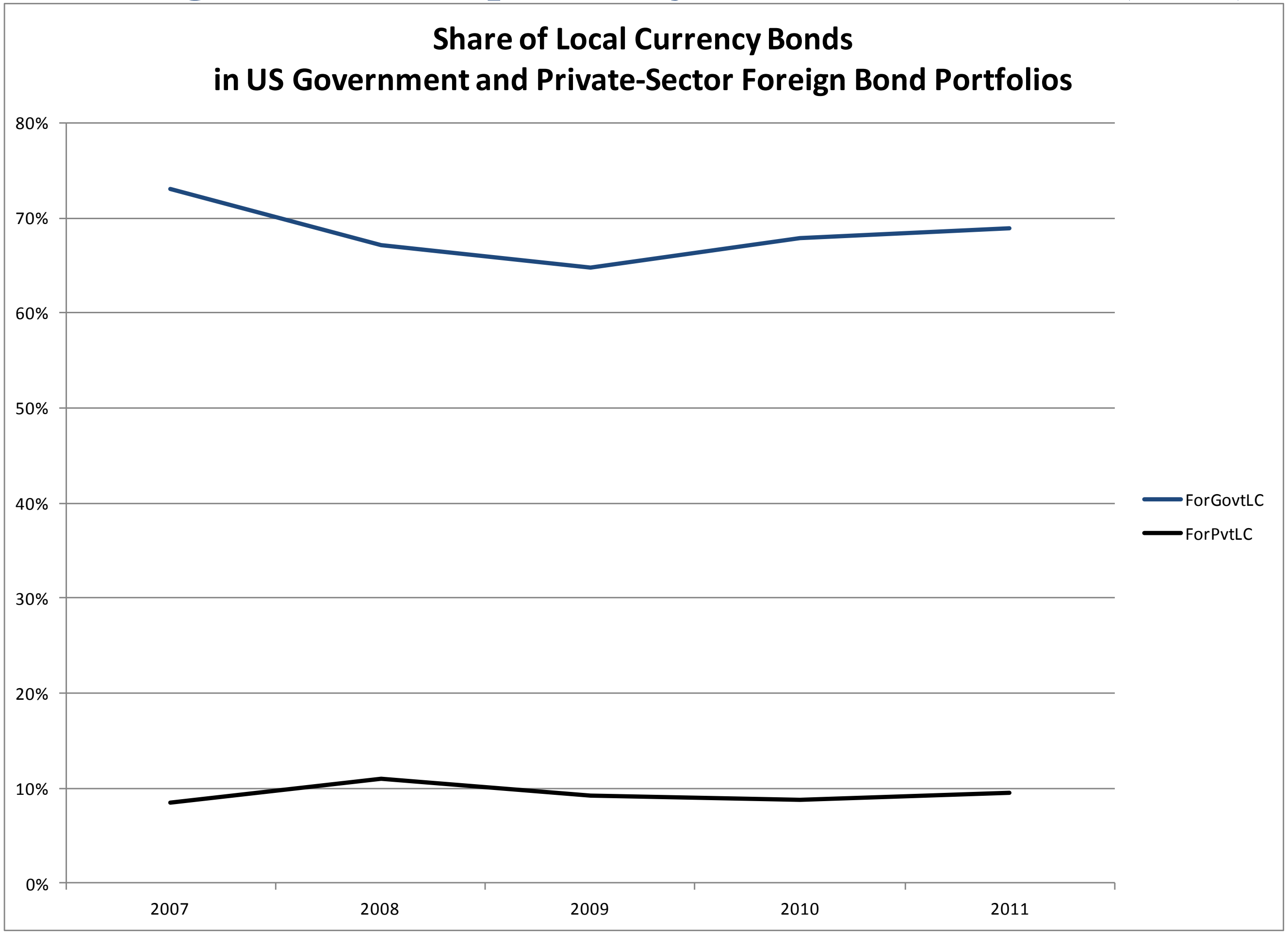
Another way of making the same point:
US holdings of private-sector foreign bonds are almost all USD-denominated (90%). Sovereign bonds are primarily LC-denominated (70%).



That said, it isn't clear this is an EME issue: USD-denom holdings are mainly in Europe ($605b,) Caribbean ($255b), and Canada ($225b).

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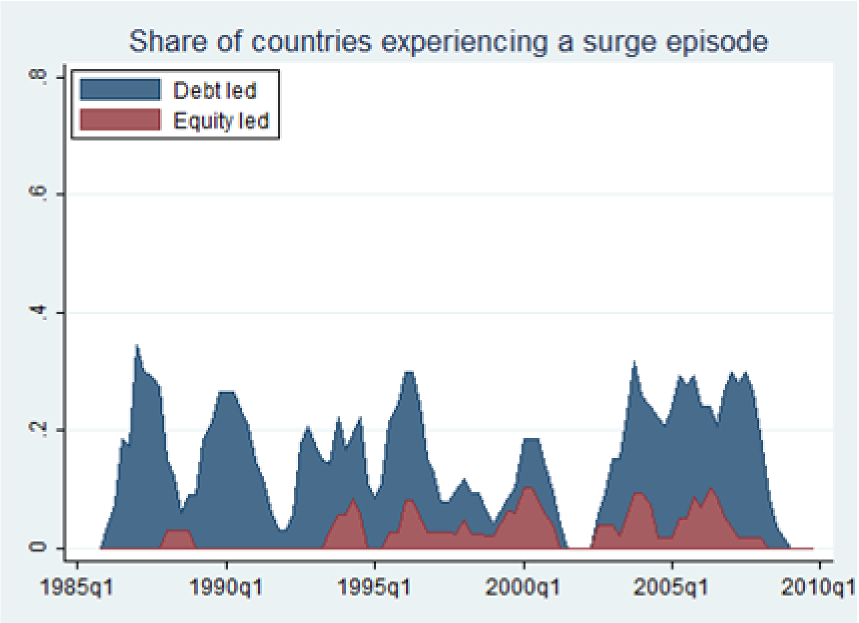
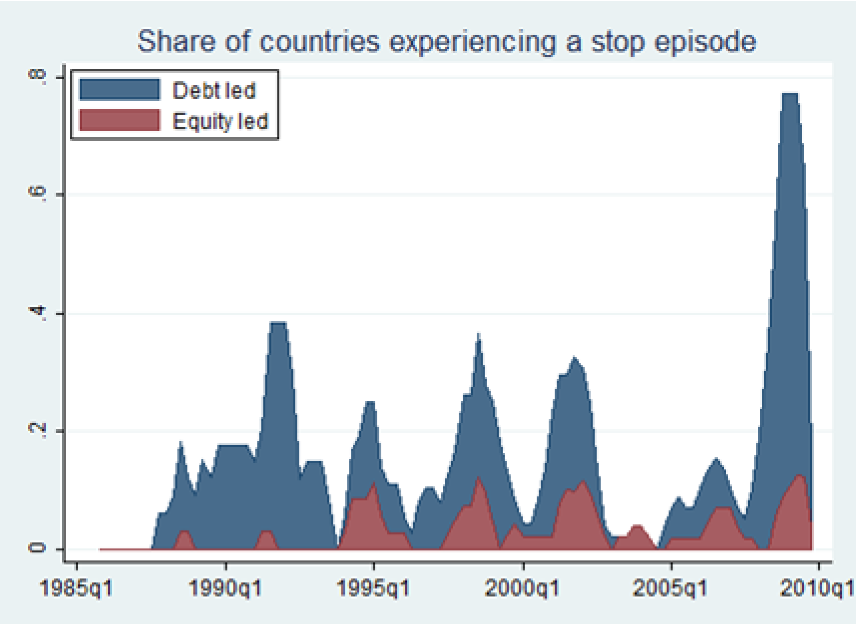
Another Issue:
80% of Extreme Capital Flow Episodes are driven by debt/bank flows





Source: Forbes and Warnock 2013 “Debt- and Equity-Led Capital Flow Episodes” Central Bank of Chile volume.

Back to my Thought Two (next to last slide)

- An important aspect of the model is that local banks obtain funding from foreigners. When the foreign funding proves fickle, to stave off defaults/liquidations it would be good to have a war chest of reserves to prop up the local firms.
  - (The war chest presumably took a decade to stock, perhaps at the expense of other reforms.)

- Another solution: Enable the development of the local bond/credit markets.
- But be clear that your highly regulated sector has robust funding models.
- It can be done…

Develop the local corporate bond market*

Malaysian corporate bond market has been sizeable for years and has strengthened over time. Many factors were central to its success. Issuance procedures were greatly improved. Merit-based regulations were replaced by a disclosure-based regulatory framework, and, to introduce a more efficient issuance process, guidelines on the offering of private debt securities were issued. 20 years ago, the approval process for bond issuance could take from 9 to 12 months; now it takes 14 days. Shelf-registration provides issuers additional flexibility in timing.

The results are tangible: The corporate bond market is attractive for issuers. Private debt securities share of total gross domestic funds raised via the capital market (i.e., bond and equity) grew to 81% in 2004 (from 44% in 1997). The share of the corporate bond market in total debt financing (including bank loans) has increased from 10 percent in 1997 to 25 percent more recently.

Investors have access to more value-relevant information for Malaysian corporate bonds than in most EMEs. Many steps have been taken to ensure efficiency and transparency in trading in an attempt to enhance secondary market liquidity. (But liquidity is hampered by a shortage of paper available for trading, small issue sizes, and the buy-and-hold investment strategy adopted by local institutions.)

Issues remain. Liquidity in the secondary market needs to improve. The swap market should be deepened. Enabling the creation of additional risk management tools, such as futures and forwards, is necessary. Further diversification of the issuer and investor base, including enhanced participation by non-residents, is desirable. But the progress has been impressive.

* Excerpt from Burger, J., F. Warnock, and V. Warnock, 2008. Ingredients of a Well-Functioning Capital Market. Korea's Economy 24: 31-38.

Thanks!