Comments on

Portfolio Flows to Emerging Market Economies
Frank Warnock and co-authors

by
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USC and the NBER

ΔR, The Current account (CA), and the financial account (FA) are linked in complex feedback loops.

After all, $CA + FA = \Delta R$.

The ambitious agenda of this paper is to estimate a system where these feedbacks will be endogenous.

These concerns are not new, but the GFC sharpened the focus on these issues.

Part I: IR accumulation

Part II: Financial flows

Part I: IR accumulation, IR is impacted by financial flows.

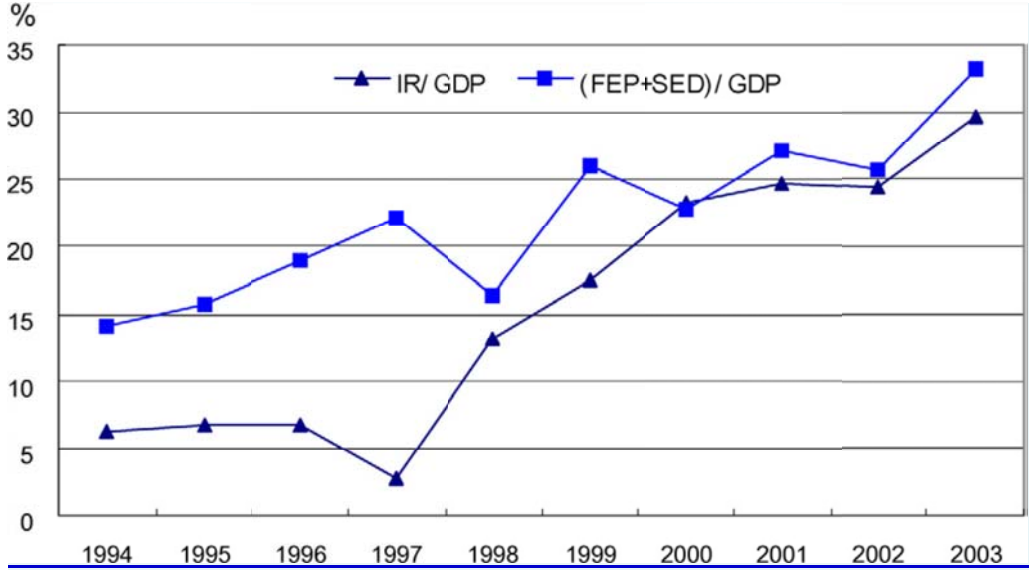
This view has received prior attention, especially after the 1997-8 crisis

Example: a case study of Korea, Aizenman, Lee, Rhee

"International reserves management and capital mobility in a volatile world: Policy considerations and a case study of Korea"
Journal of the Japanese and International Economies 2007, 1-15

"We show that the 1997-8 crisis led to structural change in the hoarding of international reserves, and that the Korean monetary authority gives much greater attention to a broader notion of 'hot money,' inclusive of short-term debt and foreigners' shareholding."

We confirm 'leaning against the wind' policy of precautionary hoarding to buffer hot money inflows and foreign purchases of Korean equities



International reserves and FEP [foreigners' equity position to GDP] + SED [short-term external debt to GDP].

The correlation between the two was +0.40 before the crisis, but increases to +0.81 after the crisis .

We confirm the impact of private financial inflows on hoarding IR using regressions similar to the one applied in the present paper.

The JJIE is part of a large body of research predating the GFC, including

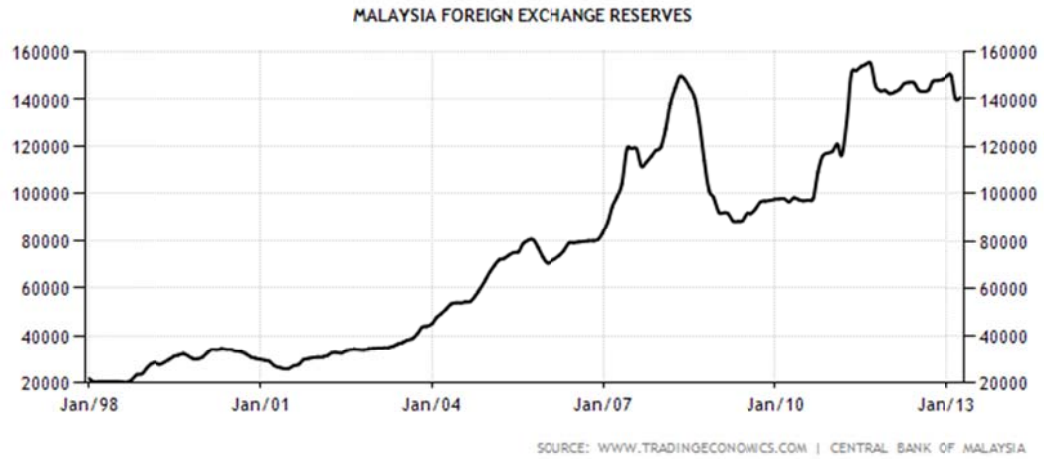
Cavoli and Rajan. Exchange rate regimes and macroeconomic management in Asia. Hong Kong University Press, 2009; and others.

The new aspect of the aftermath of the GFC is that, unlike the post 1990s crisis, EMs are experimenting with dynamic capital controls.

This is ironic: Aizenman and Lee (OER, 2007) identified growing financial integration of EMs in the 1990s and the sudden stop crises as the key explanatory variables for the rapid increase of EMs' IR/GDP ratios in the 1990s. The GFC led to EMs willingness to use prudential regulation and capital controls.

IR regressions: Possible relevant controls:

- **TOT shocks** Changes in commodity terms of trade play an important role in accounting for IR changes [REER smoothing], especially in commodity exporting countries [Argentina, Chile, Columbia, Malaysia, etc.]. See Aizenman, Edwards and Riera-Crichton (2012, JIMF)



- **Restocking effect of the crisis:** Chances are that countries that lost large share of their IR during the GFC will opt to accumulate IR after the GFC. Control for the drop of IR/GDP during the crisis.

- **Control for changes in financial regulation, *both* on financial inflows and outflows**
  The paper relies on Ahmed and Zlate (2013), who focused on measures dealing with inflows. EMs may deal dynamically with private flows by changing controls impacting both inflows, and outflows. In Aizenman and Pasricha (2013), using Pasricha's data set, we find that

"Emerging markets facing high volatility in net capital inflows and higher balance sheet exposures liberalized outflows less. Countries eased outflows more in response to higher net capital inflows, higher appreciation pressures, higher real exchange rate volatility and greater accumulation of reserves."

- **Control for PPP deviations from 'projected B-S levels'**
  This may account for hoarding IR due to REER concerns.
- **Any roles for SWFs?** These funds are frequently under the control of the public sector, de facto linked to IR policies [see the case of Chile, Hong Kong, etc.]

To conclude: an ambitious and important research agenda.

I expect the final version to move well beyond the present draft, paying attention to other important conditioning variables.
Good luck.

Thanks for your attention.