Comments on “Global Liquidity and Procyclicality”

By

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- **It was a pleasure to read the paper**
  - Emphasis on the importance of finance for the real economy
  - “Tail vs. the Brain”
- **A lot to like in this paper – but also a lot of moving parts – a collection of hypotheses**
  - Data/evidence presented are compelling, yet alternative explanations not given much attention
  - Leaves us with more questions than answers
- **Overall, thought provoking and very interesting paper which no doubt will lead to much more research in this area**

Identification?

Why are global financial conditions so attuned to the strength of the dollar?

- **Dollar denominated cross-border claims have been growing**
  - But transactions in other currencies are also growing…dollar may not be the only driving factor
  - would be good to also show how the dollar denominated cross-border claims grew vis-à-vis those in other currencies to see if the growth is disproportionately large
- **Banks lend more internationally when the dollar is weak**
  - But how much of this is a mere reflection of other currencies strengthening?
- **During the GFC, dollar appreciated strongly**
  - But how much of this was a run towards safe assets; i.e. US Treasuries

Overall, it is not clear that causality goes from the dollar to other markets; may be a reflection of a whole other set of factors at play

Other points that deserve more attention

- **Failure of Covered Interest Parity**
  - Why are the market interest rates and implied interest rates from forward rates embedded in FX swaps diverging?
  - Mention -in passing- issues of risk-taking capacity, limits to arbitrage
  - But inability of financial markets to hedge risk deserves more attention
- **Banking vs. Other Flows**
  - Focus is mostly on bank flows, which of course is central
  - However a significant part of the flows are portfolio and FDI – for many countries may now surpass bank flows. What are the implications?
- **Net vs. Gross Flows**
  - As countries grow richer gross flows increase; net flows do not show a clear trend
  - As gross flows expand, what is important is how the asset liability positions expand
  - Many EMs accumulated reserves, reduced sovereign borrowing, received FDI and equity flows…dollar appreciations and market collapses were accompanied by a strengthening of their net foreign positions

Will emerging market corporates cause the next crisis?

- **Is dollar denominated bond issuance by EM corporates a source of fragility? Carry trade…but there may be other explanations**
  - Measuring risk is difficult; do we know how much of the borrowing is unhedged?
  - EM corporates that borrow abroad in foreign currency also extend maturity (GFDR16 on Long Term Finance)
  - Governments accumulate foreign reserves and may benefit from dollar appreciation
  - Not all bond proceeds end up as cash (up to 22%) – majority used for growth opportunities
  - If large firms intermediate funds to smaller ones – this is not necessarily bad
  - What is special about EM corporates?
  - Does firm size matter?
  - Why not look at financial firms? Wouldn't they be in a better position to do carry trade?

Trade-offs…

An important implication of the paper is that while potentially an important source of economic benefits, financial globalization also has potential downsides.

- **Worsens the trade-offs monetary policy faces**
  - Inflation vs. unemployment; but also financial stability considerations
  - Focus may have to shift away from traditional goals in order to restrain debt buildups, particularly in the absence of effective macroprudential tools
- **Problems worse in an open economy because...**
  - Openness to global financial markets will inevitably reduce the effectiveness of the available macroprudential tools
  - If a bigger interest rate change is required to bring about a demand response in an open economy, this may worsen the macroprudential problem by increasing the fragility of banks and encouraging gross financial flows
  - So the trade-off between macro stabilization and financial stability becomes even worse

…and parallels

There are important parallels to banking globalization (which is the topic of next GFDR):

- Inherent tension between risk diversification and sharing as capital flows from low to high return countries and the necessity to be exposed to shocks/trends from abroad

Benefits are many:

- Resource mobilization, risk-sharing, improved competition in the domestic financial system, hence improved efficiency of resource allocation
- Foreign banks often bring new technical knowledge, improve human capital, generate demand for improving regulation and supervision, are generally less subject to political manipulation

But there are also potential costs:

- As in the GFC host countries may be exposed to external shocks transmitted by international banks, endangering stability
- International banks might fuel excessive credit booms in host countries that may end up in busts because domestic financial systems may not be capable of handling them; Pro-cyclical behavior maybe amplified by global liquidity conditions

A research agenda

Recent trends (dramatic growth since 1990s; then retrenchment as a result of the crisis; and the increase in south-south flows to at least partially compensate) raises important policy questions for developing countries and lays out a research agenda:

- Are international banks too fickle to be heavily relied upon by developing countries? As capital regulation on many European and US international banks induce them to retrench from international business, has our policy advice to developing countries changed?
- Given the rise of S-S entry, should developing countries be especially cautious? Should one worry about lack of experience or insufficient home country supervision or does their cost base and region-specific knowledge give them an advantage?
- What is the development impact of international banking particularly when it comes to access and inclusion? How will SMEs and lower income individuals be affected?
- What is the future going to look like? How do we expect technological advances and fin-tech to modify global banking? What should financial regulation and supervision look like in such a world?

There will be important trade-offs. The challenge of policy will be to maximize the benefits of bank internationalization while minimizing the costs.