Capital Flows in Risky Times: Risk-on/Risk-off and Emerging Market Tail Risk

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The paper

- Contributes to the vast literature on the drivers of capital flows to EMs
  - Applies the "at-risk" approach to examine the distribution of capital flows and returns using high frequency data
- Focuses on the impact of risk-on/risk-off (RORO) shocks
- Main contribution
  - Captures variation in global investor risk appetite through:
    - a broad RORO index, which combines advanced economy credit risk, equity market volatility, funding conditions, and currencies, and gold
    - Bekaert et al. (2020) measures of risk aversion (RA) and uncertainty
  - Characterizes the impact of changes in global risk appetite on shifts/changes in the distribution of flows/asset returns

Key findings

- RORO shocks impact the median but generally also the left tail of flows and asset returns
- Difference in bond vs. equity flows
  - Bond flows: Negative impact of risk-off shock (RORO index) on left tail (Q5) > median (Q50) > right tail (Q95) $\Rightarrow$ leftward shift in the distribution, lengthening of left tail
  - For equity flows, mainly a leftward shift in the distribution
- For asset returns
  - Risk-off shock (RORO index) shifts the distribution to the left and lengthens the tails (impact on Q5 > Q50)
  - Equity returns react much more than bond returns

Reactions

- A useful and timely paper…
  - Forces to think about the relevant measure of risk aversion and the differential impact across asset classes
  - Detailed presentation of results (over 50 pages!)
  - Overall, plausible results
- Comments
  - Measure(s) of risk aversion
  - Econometric quibbles
  - What do the results imply?

Measure(s) of risk aversion

- The two measures of risk aversion (RORO and RA) give somewhat different results—which measure to focus on?
  - Bond flows: Impact on Q5 relative to Q50 and Q95 is much larger based on the RORO shock than the RA shock
  - Equity flows: Impact on Q5 relative to Q50 and Q95 is not much different based on the RORO shock but much smaller (in fact positive) considering the RA shock
  - Returns: Impact declines from Q5 to Q95 using the RORO shock, but increases when considering the RA shock
- Is the RORO index a better measure?
- Possibly asymmetric effects of risk-off/risk-on shocks
- Time-variation in the marginal impact of RORO shocks

Econometric quibbles

- The model
  - Dynamic panel data model bias: Galvao Jr. 2011, *J. of Econometrics*
  - Restricted set of control variables: country characteristics (macro, policy, structural) and interactions (Ghosh et al., 2014 *JIE*; Gelos et al., 2019)
- Reliability of point estimates: Test for equality of coefficients
- Distribution of the risk-aversion shock varies across the flow/return quantiles
- Need to integrate the analyses of capital flows and asset returns

What do the results imply?

- Tail events present challenges for policymakers
  - Analyzing the impact of various policy tools to mitigate the effect of the risk-off shock (Fernando-Eguren Martin et al., 2020)
  - Deeper dive into some of the results
    - For example, equity flows impacted less than bond flows, but equity returns impacted more than bond returns
  - Data captures only part of the story…
    - Fund flows are a small part of overall portfolio liability flows
    - Useful to compare the impact with other investment liabilities (notably, cross-border bank flows) and FDI flows
- Implications for investors

Overall…

- An interesting and timely paper
- Helps to shed further light on the dynamics of capital flows
- Could benefit from
  - Greater clarity about the role of different risk appetite measures and which to prefer and why
  - A deeper dive into the results and policy implications