

Press Points for Chapter 2:

LONG-TERM INVESTORS AND THEIR ASSET ALLOCATION: WHERE ARE THEY NOW?

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Key Points

- Asset allocation strategies of private and official institutional investors have changed since the crisis. Most importantly, these investors are more risk conscious, including with respect to liquidity and sovereign credit risk.
- So far, in the low interest rate environment, most long-term institutional investors are choosing to accept lower returns, rather than take on more risk. Given their fixed future payments or liabilities with guaranteed returns, pressure will build for them to move into riskier assets the longer the low interest rate environment lasts.
- As heightened risk awareness and regulatory initiatives push private investors to hold “safer” assets, this may remove a set of “deep pocket” investors that helps to stabilize financial markets. There may be a role for sovereign asset managers to take on some of the longer-term risks that private investors now avoid.
- The main drivers of asset allocation decisions of long-term unleveraged institutional investors are good growth prospects, falling risks in recipient countries and higher global risk appetite. Interest-rate differentials between countries play a lesser role.
- The structural trend of investing in emerging markets has accelerated following the crisis, but the risk of a reversal cannot be discounted if fundamentals (such a growth prospects or country or global risk) change. The magnitude of recent outflows from emerging market equity and bond funds is in line with the chapter’s empirical findings on the effects of increases in global risk aversion.

This chapter examines the fundamental drivers of the longer-term asset allocation decisions of longer-term unleveraged private and public institutional investors. It looks at longer-term trends, but also asks whether asset allocation has changed as a result of the global financial crisis and the low interest rate environment.

The chapter takes as its point of departure the individual asset allocation decisions of individual investors. These decisions are at the core of financial flows between markets

currencies and countries. The chapter differs from previous studies by using disaggregated mutual fund data that has information on equity and bond investment flows into individual countries, rather than aggregated balance-of-payments data that are farther removed from the decisions of individual investors.

The analysis shows that private asset allocation is driven most strongly by positive growth prospects and falling risks in the recipient countries; interest rate differentials between countries play a lesser role. This latter finding does, however, *not* imply that capital flows in general do not respond to interest rate differentials, since they may be the result of short-term leveraged investors' decisions (such as those executing carry trades)—which this chapter does not examine.

The global financial crisis and its aftermath expose investors to two opposing forces. On the one hand, the crisis has made long-term investors more risk conscious, especially with respect to liquidity and sovereign credit risks, including those of advanced economies. On the other hand, the low interest rate environment is putting increasing pressure on institutional investors (especially insurance companies that have sold products with minimum guaranteed returns and pension funds that are underfunded) to enhance portfolio returns by investing in riskier assets.

Most institutional investors are so far accepting lower returns rather than taking on more risk. The chapter argues that this may well be evidence that the investment behavior of long-term institutional investors has fundamentally changed. This structural shift can be seen in the data: the regressions in the chapter show significant downward shifts in investment flows for the full period after the start of the crisis in mid-2007, reflecting an adjustment of portfolio flows to the new assessment of risks, and there is so far no evidence that this effect is fading. Nevertheless, if—as expected—interest rates in advanced economies stay low for an extended period, such investors will be under increasing pressure to take on more investment risk, as their financial situation becomes increasingly unfavorable.

The structural trend of investing in emerging markets has accelerated following the crisis. However, with many first-time investors taking advantage of the relatively better economic performance of these countries, there is a risk of a reversal if fundamentals change. For larger shocks, the impact of such reversals could be of the same magnitude as the pullback in flows experienced during the financial crisis. Indeed, the magnitude of recent outflows from emerging market equity and bond funds (which occurred after the chapter was finalized) is in line with the chapter's empirical findings.

The chapter suggests that sovereign asset allocation may provide a counterweight for changing private sector behavior. The chapter suggests that heightened risk awareness and initiatives like Solvency II for European insurance companies may push these institutions away from their traditional role of taking on longer-term risky assets, potentially dampening the positive impact of one class of “deep pocket” investors that are willing to hold illiquid assets through market downturns. As private investors are pushed to hold “safer” assets, there may be a role for sovereign asset managers to take on some of the longer-term risks that private investors now avoid.

PRESS POINTS FOR CHAPTER 3:

Towards Operationalizing Macroprudential Policies: When to Act?

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Prepared by Srobona Mitra (team leader), Jaromír Beneš, Silvia Iorgova, Kasper Lund-Jensen, Christian Schmieder, and Tiago Severo.

Key Points

- Employing macroprudential policies correctly will require improved understanding of the source of shocks leading to systemic risk buildup. Good leading indicators of systemic risk buildup should help decipher good shocks (like productivity gains) from bad shocks (such as asset price bubbles).
- Credit growth, at the heart of buildup in systemic risks, needs to be accompanied by other indicators, such as increases in asset prices and foreign bank liabilities as well as real exchange rate appreciations, to tell apart the two types of shocks.
- One good indicator of credit growth is the change in the ratio of credit-to-GDP. Using a sample of 36 countries, our model finds that when the credit-to-GDP ratio increases by more than 5 percentage points per year and is accompanied by equity price rises by 15 percent or more, the probability of a financial crisis within the next two years is one-in-five.
- High-frequency market-based indicators are best at indicating when systemic risk is about to materialize within a few months. An indicator that builds on the LIBOR-OIS spread and the yield curve is shown to be effective in such a task.
- There are a number of tools policymakers can use to lessen the chances of a financial crisis. The chapter tests one of them, countercyclical capital requirements, and shows that it can be useful to lessen the variability of business cycles and the likelihood of financial distress.
- Macroprudential and monetary policymakers need to coordinate in at least two areas: understanding the basic source of shocks and their policies in managed exchange rate regimes with widespread foreign currency lending.

Macroprudential policy seeks to reduce the risk of severe disruption to system-wide financial services, or “systemic risk,” which could have serious adverse effects on the real economy. Operationalizing macroprudential policies is a multifaceted task, and the analysis in this chapter takes concrete steps along several paths to reach this goal. It exploits a model of macroeconomic-financial linkages to explore how different indicators behave in response to various sources of shocks to the economy. Empirical exercises bolster support for the types of additional information needed to best flag the buildup of risk. Furthermore, the analysis suggests a set of high-frequency indicators that could alert policymakers to the

imminent arrival of financial distress. We find, using model-based analytical insights, that one popular macroprudential tool—countercyclical capital requirements—would work under different exchange rate regimes.

Effective monitoring of systemic risk and effective policy responses depend critically on accurate identification of the sources of shocks to the economy. The chapter finds that the source of shocks drives movements in some economic data that are associated with systemic risk buildup. Differences in the financial structure of an economy change the magnitude of the effects of shocks but not their direction so the lessons can be used very broadly. Policymakers should devote resources and coordinate with each other to better understand the sources of shocks, particularly those that are cross-border.

Among slow-moving indicators of the build-up of risk, aggregated credit information is useful but needs to be complemented by other indicators. Even though credit increases with both a good shock (a healthy boost to the real economy through productivity increases) and a bad shock (such as booming asset prices and relaxed lending standards by banks), the increase and the persistence of credit and the decline in bank capitalization ratios are significantly higher in the case of the bad shocks. Other indicators accompanying credit growth form powerful signals. If credit is growing by more than 5 percentage points of GDP, and is accompanied by an increase in equity prices of 15 percent or more, this pushes the probability of a crisis to 20 percent within two years. The signal is stronger if a broader measure of credit—bank-based and direct cross-border loans to the private sector—is used. In the context of emerging economies, real exchange rate appreciation appears to be a particularly relevant factor.

Policymakers should also examine high frequency indicators to prepare for the potential near-term materialization of a crisis and the release of built-up buffers. Among such indicators, this chapter finds that an indicator based on the LIBOR-OIS spread and the yield curve could signal the potential materialization of stress well. Indicators that contain information about interconnectedness across financial institutions, however, did not perform well in signaling the failure of Bear Stearns and Lehman in advance, suggesting policymakers may have to rely on actual information on cross-institutional exposures to assess the potential for domino effects if a crisis were to materialize.

We find that a similar set of macroprudential tools can be effective across different types of economies, which should help to facilitate policy coordination at the international level. However, the *calibration* of policy instruments—especially those based on thresholds for different indicators—differ according to country-specific circumstances. For instance, managed exchange rates and the use of loans denominated in foreign currency amplify the effects of all shocks. Thus close coordination of exchange rate, monetary, and macroprudential policies is essential to achieve a more stable financial sector and real economy in these situations.