
ALPHAVILLE

[HOME](#) [MARKETS LIVE](#) [LONG ROOM](#)

Capitalism **IPOs** **Globalisation** **Asset allocation**

What if there isn't a "global financial cycle" after all?

5

SEPTEMBER 12, 2017 1:00 AM

By: **Matthew C Klein**

There is a potent global financial cycle in gross capital flows, credit creation and asset prices, which has tight connections with fluctuations in uncertainty and risk aversion.

–Helene Rey, [August 2013 \(https://www.kansascityfed.org/publicat/sympos/2013/2013Rey.pdf\)](https://www.kansascityfed.org/publicat/sympos/2013/2013Rey.pdf)

Centre-country phenomena and common factors do not explain much of the time series variation in capital flows...Periods of financial stress – that is, high and/or rapidly rising values of the VIX or the dollar – do not seem to be systematically associated with unusual capital flow movements (at the quarterly frequency) across our sample of countries.

–Eugenio Cerutti, Stijn Claessens, and Andrew K Rose, [August 2017 \(http://www.bis.org/publ/work661.pdf\)](http://www.bis.org/publ/work661.pdf)

Rey's thesis makes a lot of intuitive sense. Most of the world's assets are owned by the well-to-do in the big rich countries. Small changes in their preferences can have big effects on smaller, poorer countries. For example, if enough money managers raise or cut their allocation to Turkey by a percentage point, it would lead to hundreds of billions of dollars in inflows or outflows.

It's therefore reasonable to think that rich-country savers tend to react to economic conditions in similar ways – aggressively investing in "emerging" markets and tech IPOs

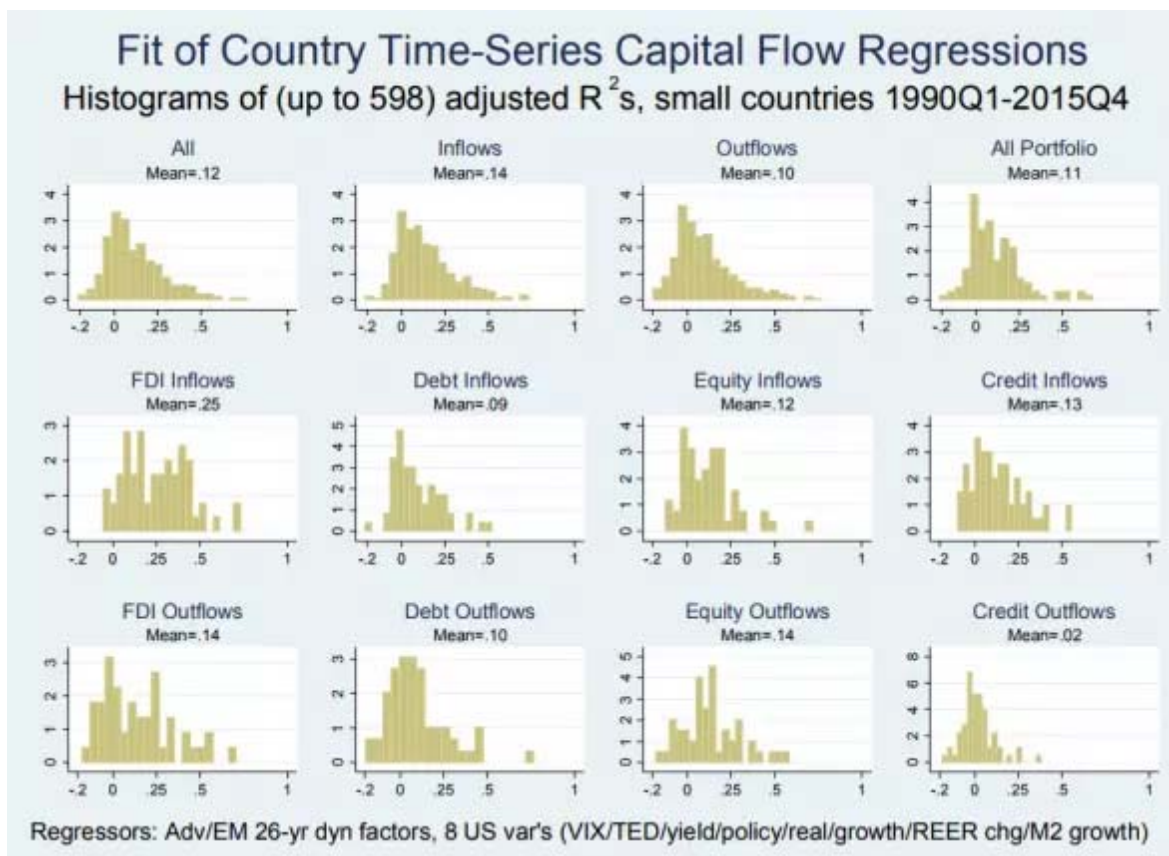
when they're worried about missing out on the next big thing, and hoarding gold and Treasury bonds when they're afraid of losing money — and that these behaviours produce a common “global financial cycle” across otherwise unrelated countries.

That helps explain why policymakers in places such as [Brazil \(https://www.ft.com/content/33ff9624-ca48-11df-a860-00144feab49a\)](https://www.ft.com/content/33ff9624-ca48-11df-a860-00144feab49a) and [Korea \(https://www.wsj.com/articles/SB10000872396390443328404578022110261892852\)](https://www.wsj.com/articles/SB10000872396390443328404578022110261892852) were so peeved by the Federal Reserve's post-crisis bond-buying. Their concern was that the Fed, which was inelegantly trying to boost domestic spending, was pushing American savers to finance excesses in abroad. When the Fed eventually reversed policy, those flows would presumably go [from suck to blow \(https://www.youtube.com/watch?v=ZXOAc5yt218\)](https://www.youtube.com/watch?v=ZXOAc5yt218). If this theory were correct, the net effect would be a boom-bust cycle imposed on poorer countries by American central bankers.*

[New research \(http://www.bis.org/publ/work661.pdf\)](http://www.bis.org/publ/work661.pdf) from economists at the Bank for International Settlements, the International Monetary Fund, and the University of California-Berkeley, however, suggests otherwise.

They ran a series of tests on different kinds of capital flows and a range of plausible measures of the “global financial cycle” — the volatility index, output growth, nominal and real policy interest rates, the trade-weighted dollar, the slope of the US yield curve, the bill-Libor spread, M2 — and found little explanatory connection. The data since 1990 show basically no relationship between global capital flows and any conceivable measure of rich-world risk appetite.

The researchers also ran their tests for each country's capital flows individually. It's possible, after all, that the average results were distorted by a few outliers. But that's not what happened. The outliers are the handful of countries supporting Rey's global financial cycle thesis (emphasis ours):



The mean R^2 is only .12, over a quarter of R^2 s are negative, and only a few exceed .5. This pattern is widespread across different subsets. Across the top row of Figure 5 to the right are analogous histograms which cover capital flow regressions for inflows, outflows and portfolio flows, respectively; all three are similar to the top left-hand histogram. In the two rows below are a set of eight histograms presenting R^2 s for capital flows by direction and type. FDI inflows are the easiest capital flows to model statistically, a pattern we find consistently throughout our research, but even there the mean R^2 is only .25.

Thus the evidence from the dozen histograms of Figure 5 indicates that **conventional time series models of capital flows do not fit small countries well**, even when incorporating eight centre-country variables and two capital flow factors. Given that the GFCy [global financial cycle] should be present in both the variables (particularly the VIX) and the capital flow factors, **it is hard to reconcile this evidence with a GFCy that explains much variation in capital flows for many countries.**

The positive conclusion from all this is that the post-crisis fetish for capital controls is overdone. Floating exchange rates, sensible domestic financial regulation, and reasonable

macro management should be sufficient to avoid problems without resorting to autarky or massive foreign exchange reserves:

If, as our results suggest, the GFCy explains only a small fraction of the variation in capital flows, then more idiosyncratic phenomena necessarily explain capital flows. To the extent that these are idiosyncratic foreign phenomena, it will be difficult to put in place systematic policies that screen "good" from "bad" capital flows, and the country is thus more likely to give up the gains of international financial integration as it tries to insulate itself. And, regardless, it may be more natural to identify much of this idiosyncrasy with domestic phenomena, making it incumbent on the policy authorities of countries on the periphery to take ownership of and responsibility for these.

Related links:

[The BIS thinks capital controls are dumb \(https://ftalphaville.ft.com/2017/04/19/2187688/the-bis-thinks-capital-controls-are-dumb/\)](https://ftalphaville.ft.com/2017/04/19/2187688/the-bis-thinks-capital-controls-are-dumb/) — FT Alphaville

[If Spain didn't need capital controls, why would anyone? \(https://ftalphaville.ft.com/2016/07/15/2168347/if-spain-didnt-need-capital-controls-why-would-anyone/\)](https://ftalphaville.ft.com/2016/07/15/2168347/if-spain-didnt-need-capital-controls-why-would-anyone/) — FT Alphaville

[The dollar is still our currency and still your problem \(https://ftalphaville.ft.com/2015/01/22/2096392/the-dollar-is-still-our-currency-and-still-your-problem-2/\)](https://ftalphaville.ft.com/2015/01/22/2096392/the-dollar-is-still-our-currency-and-still-your-problem-2/) — FT Alphaville

[It Was Barzini All Along \(http://www.epsilontheory.com/notes/it-was-barzini-all-along/\)](http://www.epsilontheory.com/notes/it-was-barzini-all-along/) — Epsilon Theory

**As it happens, the aggregate effect of the Fed's asset-purchase programmes was to encourage foreign savers (https://ftalphaville.ft.com/2015/01/22/2096392/the-dollar-is-still-our-currency-and-still-your-problem-2/) to finance dollar-denominated borrowing by non-Americans. US investors seem to have reacted to Fed stimulus more by encouraging additional corporate leverage than by flooding poorer countries with hot money.*

[Copyright \(http://www.ft.com/servicetools/help/copyright\)](http://www.ft.com/servicetools/help/copyright) The Financial Times Limited 2017. All rights reserved. You may share using our article tools. Please don't cut articles from FT.com and redistribute by email or post to the web.

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others. © The Financial Times Ltd.

Read next:

Part of the **ICOMedy series**

The FCA's belated views on the ICOMedy

Part of the **ICOMEDY SERIES**



About us

Firms

Markets

Home / News / Initial Coin Offerings

Initial Coin Offerings

If you count the DAO as ICO patient zero, it only took them over a year... If you count the ether fundraising as patient zero, it only took them over three years.

4 HOURS AGO By: Izabella Kaminska

10

