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Official financial flows, capital mobility, and global imbalances☆

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A B S T R A C T

We use a cross-country panel framework to analyze the effect of net official flows (chiefly foreign exchange intervention) on current accounts. We find that net official flows have a large but plausible effect on current account balances. The estimated effects are larger with instrumental variables (42 cents to the dollar on average compared to 24 without instruments), reflecting a possible downward bias in regressions without instruments owing to an endogenous response of net official flows to private financial flows. We consistently find larger impacts of net official flows when international capital flows are restricted and smaller impacts when capital is highly mobile. A further result is that there is an important positive effect of lagged net official flows (embodied in the lagged stock of official assets) on current accounts that we believe operates through the portfolio balance channel.[1]

1. Introduction

Government-directed, or official, financial flows (dominated by purchases of foreign exchange reserves) have exploded over the past 15 years and are now running at more than $1 trillion per year.

☆ The views expressed here do not necessarily reflect those of the International Monetary Fund or the Peterson Institute.

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[1] Note the following abbreviations: BOP, balance of payments; COFER, composition of official foreign exchange reserves (data); ICRG, international country risk guide; IMF, International Monetary Fund; PPP, purchasing power parity; SWF, sovereign wealth fund; UIRP, uncovered interest rate parity; WGI, world governance indicators. [This does not include abbreviations that are used only in equations and text discussion of those equations.].

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Current account imbalances also reached record levels and remain a major source of tension in the international policy debate, despite a partial retrenchment since 2007. Advanced economies see emerging ones as frustrating needed current account adjustment via reserve accumulation. Emerging economies see their advanced brethren as trying to export their way out of recession via loose monetary policies that tend to weaken their currencies.

This paper explores the first of these two arguments: Do official flows frustrate current account adjustment? Of particular interest is the extent to which official flows have a greater impact on current accounts in the presence of capital controls or other barriers to capital mobility. In addition, we explore whether there is a longer lasting impact of official flows on current accounts through the portfolio balance channel.

The paper follows in the footsteps of Chinn and Prasad (2003), Chinn and Ito (2008), Lee et al. (2008), and others who use a cross-country time-series approach to estimate the underlying determinants of current accounts. Bayoumi and Saborowski (2014), Gagnon (2012, 2013), and IMF (2012, 2013) augment the Chinn and Prasad framework to include reserve accumulation or net official financial flows as a measure of a government's exchange rate policy.[2] All five studies find a significant effect of net official flows on the current account balance. The main contributions of this paper are the use of a novel set of instrumental variables to better isolate exogenous from endogenous official flows; exploration of the interaction of capital mobility with the effects of official flows using a variety of measures of capital mobility; and consideration of lagged effects of official flows embodied in lagged stocks of net official assets.

The potential endogeneity of official flows to shocks to current account balances and net private flows is a key issue. Endogenous movements are most likely to arise from attempts to stabilize the exchange rate in the face of trade or financial market shocks. We propose a set of instruments chosen to reflect possible exogenous reasons why policymakers may choose to accumulate official assets and liabilities, including saving resource revenues for future generations, borrowing for economic development, achieving higher net exports, or building a war chest against future volatility.

We find that net official flows have a large but plausible effect on current account balances. The estimated effects are larger with instrumental variables, reflecting possible downward bias in regressions without instruments owing to an endogenous response of official flows to private financial flows. We also find that the impact of net official flows is importantly affected by the extent of capital mobility. Net official flows have a larger effect on the current account when capital mobility is low.

A further result is that there is an important effect of lagged net official flows, captured by the coefficient on the lagged stock of net official assets. We believe this effect operates through the portfolio balance channel. Persistent changes in relative supplies of assets in different currencies have persistent effects on exchange rates and current account balances. This effect often increases with capital mobility, probably indicating that the portfolio channel is less important when private flows are tightly restricted.

The paper is organized as follows: Section 2 presents the arguments underlying our hypotheses and discusses measures of capital mobility. Section 3 motivates our empirical specification. Sections 4 and 5 present the baseline regression results and associated robustness checks. Section 6 illustrates the fitted model for individual countries and Section 7 concludes.

2. Background and motivation

2.1. Current accounts and official flows

We define official financial flows as the acquisition and disposition of assets and liabilities denominated in foreign currencies by public-sector institutions in the reporting country.[3] The

[2] Reinhart et al. (2010) find that reserve accumulation is positively associated with the current account, mainly for countries with capital controls. Aizenman et al., (2013) also find a positive connection between reserve accumulation and current accounts.

[3] We assume that monetary policy fully offsets, or "sterilizes," any potential inflationary effects of accumulation of foreign assets, whether by the monetary authority or by other public institutions. We conduct some tests that support this assumption.