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Hot money in bank credit flows to emerging markets during the banking globalization era



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ABSTRACT

This paper investigates the relative importance of hot money in bank credit and portfolio flows from the US to 18 emerging markets over the period 1988–2012. We deploy state-space models à la Kalman filter to identify the unobserved hot money as the temporary component of each type of flow. The analysis reveals that the importance of hot money relative to the permanent component in bank credit flows has significantly increased during the 2000s relative to the 1990s. This finding is robust to controlling for the influence of push and pull factors in the two unobserved components. The evidence supports indirectly the view that global banks have played an important role in the transmission of the global financial crisis to emerging markets, and endorses the use of regulations to manage international capital flows.

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“When one region of the world economy experiences a financial crisis, the world-wide availability of investment opportunities declines. As global investors search for new destinations for their capital, other regions will experience inflows of hot money. However, large capital inflows make the recipient countries more vulnerable to future adverse shocks, creating the risk of serial financial crises.”
(Korinek, 2011)

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1. Introduction

International capital flows increased dramatically in the 1990s and it has been argued that they eventually led to the 1997 Asian Financial Crisis (Kaminsky and Reinhart, 1998; Kaminsky, 1999; Chari and Kehoe, 2003). International capital flows resurged again until the late 2000s Global Financial Crisis (GFC). Global capital flows increased rapidly from less than 7% of world GDP in 1998 to over 20% in 2007, but suffer large reversals in late 2008, with bank credit flows being hit the hardest (Milesi Ferretti and Tille, 2011; Tong and Wei, 2011; Forbes and Warnock, 2012). Is this reversal of global capital flows due to *hot money*?

The term *hot money* has been most commonly used for capital moving from one country to another in order to earn a short-term profit on interest rate differentials or anticipated exchange rate shifts. This speculative capital can lead to market instability (Martin and Morrison, 2008; Chari and Kehoe, 2003).¹ Recently, the equity premium has been suggested as a driver of hot money (Guo and Huang, 2010). Instead of ascertaining driving factors, some studies have sought to identify *hot money* via the unobserved-component models by focussing on its temporariness and reversibility aspects (see, e.g., Sarno and Taylor, 1999a,b).

A surge in hot money to emerging markets (EMs) may be destabilizing and trigger regulation, of which examples abound since 2009 such as Brazil, Taiwan, South Korea, Indonesia and Thailand among other countries. Thus, measuring hot money becomes crucial for appropriate policy design (IMF, 2011; Ostry et al., 2010; McCauley, 2010; Korinek, 2011).

It is well known that distinct types of capital flows have distinct degrees of reversibility (Tong and Wei, 2011; Sarno and Taylor, 1999a).² In fact, a key feature of the post-1990s trend in capital flows to EMs up until the GFC is the dramatic resurgence of international bank credit flows relative to equity and bond flows (Bank for International Settlements, 2009; Goldberg, 2009). Using Bank for International Settlements (BIS) statistics, Milesi Ferretti and Tille (2011) show that the holdings of cross-border bank credit at year-end has increased notably, especially, during 2000–2007 and reached about 60% of world GDP. Thus, banking flows were hit the hardest compared to other types of capital flows during the GFC (Milesi Ferretti and Tille, 2011). It is also recognized that the recent bank globalisation process has played a major role in the GFC transmission (Aiyar, 2012; Cetorelli and Goldberg, 2011, 2012a,b; De Haas and Van Horen, 2013; Giannetti and Laeven, 2012).

Such recent developments in international capital flows and especially in bank credit flows raise questions such as whether the banking sector played a key role in the transmission of the crisis to emerging markets as the literature on bank globalisation suggests. Related to that is the question how the relative amount of hot money in bank credit, and portfolio (equity and bond) flows has evolved in recent years, particularly, in the run-up to the late 2000s GFC?

This paper takes up the latter question by probing whether the relative importance of hot money in bank credit and portfolio flows to EMs has changed over the 1988–2012 period. We start by deploying unobserved component (or state-space) models à-la Kalman filter to gauge the temporariness of international capital flows from the US to 9 Asian countries and 9 Latin American countries which have attracted substantial capital flows over period the 1988–1997. We are able to confirm the earlier findings of Sarno and Taylor (1999a,b) over a similar time period and using a similar methodology. On average in the 1988–1997 period, portfolio flows (*i.e.*, equity and bond flows) were largely

¹ Huge movements of hot money have been historically not atypical in fixed exchange rate systems (e.g., during the final years of the Bretton Woods system). Recently, there is a growing interest on carry trade, seen as a type of hot money (McKinnon and Schnabl, 2009; McCauley, 2010; McKinnon, 2013; McKinnon and Liu, 2013).

² It is usually referred as the *composition* hypothesis. The rationale is that a more volatile form of capital will be more likely to fly out of the country in crisis. Tong and Wei (2011) do not find a connection between a country's exposure to capital flows and the extent of the liquidity crunch experienced by its manufacturing firms when they just include total volumes of capital inflows. However, they argue this masks an important compositional effect, as a different but consistent pattern emerges when they disaggregate capital flows into three types (FDI, foreign portfolio flows and foreign loans). This empirical evidence suggests that aggregating different capital flows may not be appropriate when one wishes to understand the connection between capital flows and a liquidity crunch in a crisis. See also Neumann et al. (2009) and Levchenko and Mauro (2007).

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