The Risk-Taking Channel of International Financial Flows

Pietro Cova and Filippo Natoli
Bank of Italy

Discussant: Yabin Wang
Hong Kong Monetary Authority

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Summary

- The main research question of this paper is to jointly identify the effects of financial flows from global banks and global public institutions on US financial conditions and macroeconomic stability in the run-up to GFC
- This paper focuses on the cross-border flows from the “banking gluts” European banks into the US corporate bonds, and from the “saving gluts” Asian countries into the US public bonds, from 1994 to 2007
- The authors find that the flow of funds associated with both BG and SG play an important role in easing financial conditions and encouraging risk-taking in the US, independent from the accommodative US monetary policy

Research Questions

- Provides both a joint and independent test of the two narratives about the "culprits" of GFC
    - "Global saving glut" (Bernanke 2005) - e.g. China held US Treasuries because of limited choice of investment and the demands for safe assets; led to low interest rate environment, stoke the permissive financial conditions and possibly led to more risk-taking in the US
    - "Global banking glut" (Shin 2011) - associated with the explosive growth of cross-border lending, especially through European banks sustaining the shadow banking system of the US, drawing on wholesale dollar funding on the one hand and lending to US securitized market in return (highlighting the importance of net capital flow)

Empirical Approach

- Test the impact of the two financial inflows on US economic condition and financial stability
- Mechanism: foreign inflows are conducive for a loosening financial condition in the US, and a reduction in riskiness which stimulates bank over-lending (independent from the US monetary policy)
- Empirical findings:
  - Negative effect on the long term interest rate (US 10-yr Treasury yield and US AAA corporate bonds yield)
  - Corporate bond inflows show compression of the credit spread and VIX via lower risk premia
  - Contributed to rise in bank leverage
- Identification for reverse causality: Granger causality test

Empirical Approach

- Test the persistence and dynamic of the responses of the US macroeconomic variables and aggregates to the two financial inflows shocks
- Mechanism: both types of inflows reinforce each other, they are driven by risk on/off periods but also lead to these periods
- Variables of interests in a BVAR:
    - Treasuries and corporate inflows
    - Bank leverage
    - Excess bond premium
    - VIX index
    - US REER and real FFR
- Identification for exogeneity to US monetary policy: testing correlation between structural shocks

Comments

- This paper is well-written, the analysis is appropriate and clearly presented and results are carefully analyzed
- Main comments:
  1. Global banks and Asian investors: who is the major player in generating the reduction in risk premia thus stoke the risk taking?
  2. The flight-to-safety flows push down risk-free rate, which through portfolio effect may also push down the corporate bond yield regardless of the global banking behavior. Would it be possible to disentangle to what extent the reduction in risk premium is brought by search-for-yield behavior of global banks?
  3. Global banks actively engage in cross-border lending not only through purchasing US corporate bonds, but also in serving as an intermediator for syndicated loans to firms. Is it possible to quantify the effect on loan risk premium as another proxy for loosening financial condition?