A Model of Fickle Capital Flows and Retrenchment

Ricardo Caballero Alp Simsek

Discussion by Matteo Maggiori
Harvard University

2018 NBER

The Paper & The Discussion

The paper:

- A Model of Capital Flight and Retrenchment
- Argues increase in gross capital positions not necessarily unstable in a symmetric world
- Studies some asymmetric cases: search for safety or yield

The discussion:

- A summary of the facts
- A summary of the model
- Gross positions as risk sharing

Flight and Retrenchment

Most previous literature:

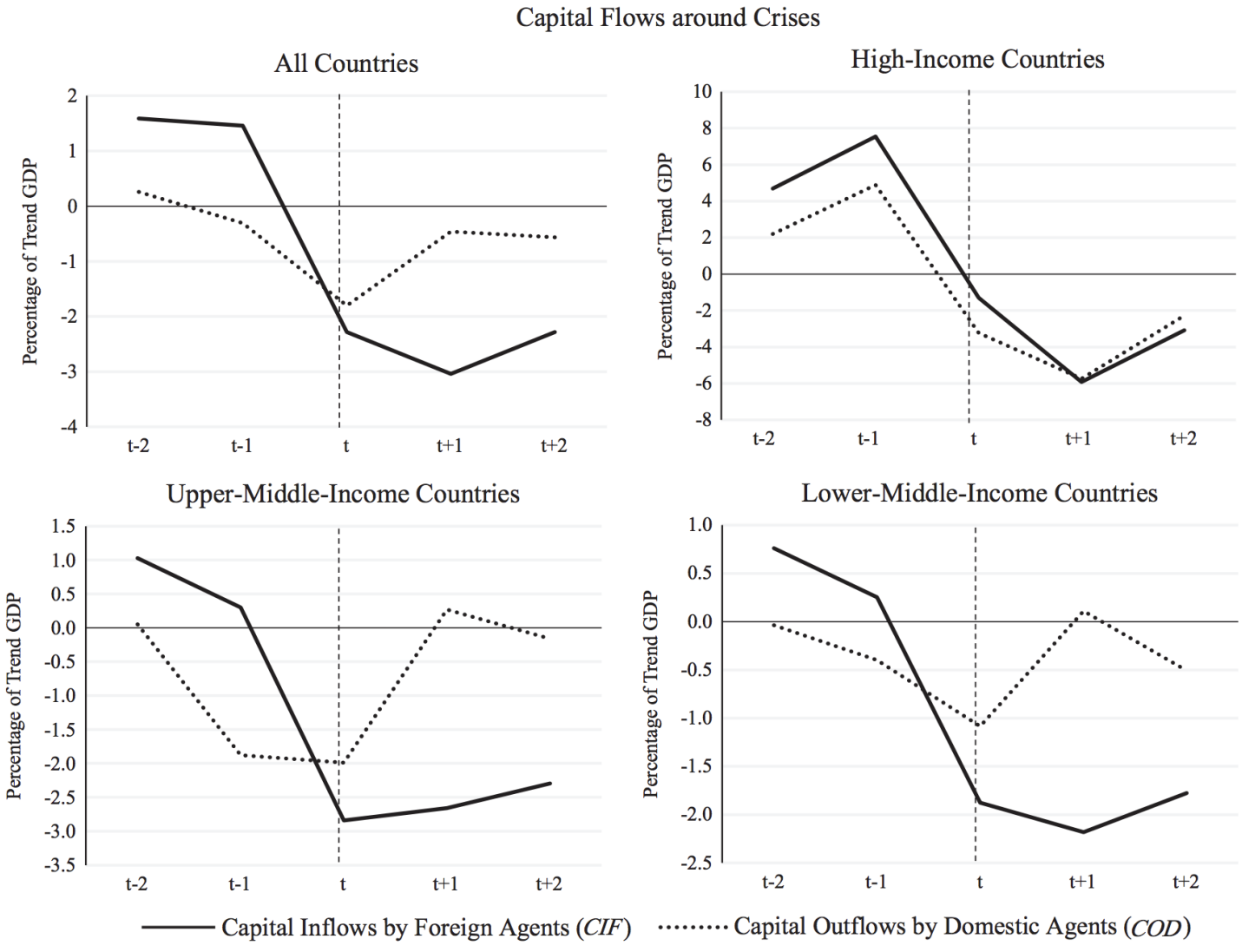
- Foreign capital is "flighty", it flows out of a country at the first sign of trouble
- Locals are long-term investors willing to suffer the ups and down of the market
- Foreigners pulling out inefficiently depress local prices (fire sales)

The most recent literature:

- Locals also invest abroad (they are "foreigners" in the other countries)
- When a crises happens they retrench from foreign investments

Flight and Retrenchment

F. Broner et al. / Journal of Monetary Economics 60 (2013) 113–133



Logic of the Model

$$p_s = \frac{\eta + x(1-\pi_s)R}{e + x(1-\pi_s)}$$

- Capital outflow x depresses local prices p_s
- Capital inflow x supports local prices p_s
- When foreigners sell the domestic risky asset in a crisis they do so at a depressed price p_s
- When locals sell abroad the risky asset, they recover the full price $R > p_s$
- If $\pi_s < 1$ and $\eta > eR$, then p_s is increasing in x

Important Features

- Assumption: If a location experiences a liquidity shock, then foreign banks are required to sell the asset, while local banks are not
- Local banks are the local liquidity providers, they buy distressed assets and support local markets
- In the data, local banks are most often distressed sellers, they exacerbate the fire sales
- Could improve mapping of model actors to real world (see Remark 2)

Welfare Results

- Allocation is constrained inefficient due to pecuniary externalities
- Individual countries can improve their own welfare by regulating outflows
- Nash outcome of individual countries' regulation is inefficient: too few capital flows, not enough liquidity
- Liquidity in the model has a public good aspect

Asymmetric Risk Sharing

- Main model has symmetric countries
- Global risk sharing in the data is not symmetric
- US sells liquid-safe assets and buys illiquid-risky assets to RoW
- Consider a country (measure zero) with enough safe asset to avoid fire-sales in autarky ($\eta^* > \eta$)
- When financial markets are opened for trade this country:
  - Exports liquidity
  - Imports financial crises, i.e. experiences fire-sales in a crisis

Conclusions

- Nice paper!
- Makes a sophisticated case for a stabilizing role of gross flows since they are a symptom of risk sharing