Comment on "Growing importance of investment funds in capital flows" by Richard Schmidt and Pınar Yeşin

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The remarkable growth of non-bank financial institutions (NBFIs) since the Great Financial Crisis has put them put them front and center on policy-makers' agendas. In principle, NBFIs can contribute to a more diversified funding mix, with attendant positive repercussions on the real economy and financial stability. At the same time, they can be a source of instability due to hidden leverage, liquidity mismatches or their potential contribution to fire sales and market illiquidity.

An important aspect of the growing footprint of NBFIs is the rise of investment funds, both passive and active. The cross-border dimension of this phenomenon is particularly important, not least from a policy perspective, as the investment behavior of foreign funds can significantly impact financial conditions in recipient countries. There is a rich and well-established literature on the impact of capital flows.

In their paper, Schmidt and Yeşin analyze the footprint of investment funds in capital flows.[2]

They do so by combining high-frequency data on investment funds' assets under management from EPFR (for both equity and bond funds) with lower frequency balance of payments data from the IMF for a sample of 20 advanced and 13 emerging economies. The intermediate goal is to estimate the share of portfolio equity and bond liabilities to foreign-domiciled investment funds. This requires that they clean the EPFR data to tease out the cross-border component of investment funds' positions, an interesting exercise in and of itself – useful not least from a policy monitoring perspective.

Schmidt and Yeşin show that the external exposure of countries to foreign-domiciled investment funds has been increasing both for advanced and emerging economies, and it is on average larger for the latter. This is in line with related research and policy work documenting the growing footprint of NBFIs, and

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2 The paper contributes to a growing literature on the causes and consequences of the rise of NBFIs, as well as the impact on capital flows; see Aramonte et al. (forthcoming), Aldasoro et al. (2022), Converse et al. (2021) and references therein.

could have important implications for how key macroeconomic variables in those economies respond to shifts in foreign investor sentiment. The authors further use the data to nowcast portfolio bond and equity liabilities from the balance of payments, with mixed success (i.e., good for equity for most countries, not as good for bonds).

Armed with countries' exposure to foreign-domiciled investment funds, they then study the attendant impact of those fund flows on domestic variables such as the exchange rate and asset prices, focusing on emerging markets during March 2020. Fund flows, broadly defined to encompass both domestic and cross-border, positively affect equity prices and negatively affect bond yields, while also being associated to an appreciation of the domestic currency. Surprisingly, the latter finding on exchange rates is not present when focusing on foreign-domiciled funds only.

Finally, the paper applies the methodology of identifying foreign-domiciled funds' positions in order to provide stylized facts about the rapidly growing environmental, social and governance (ESG) element of investment funds. They also find these have been on the rise, for both bond and equity funds, as well as across advanced and emerging economies.

The contribution by Schmidt and Yeşin provides a useful starting point for a research agenda, which could benefit from some clarifications and which could be extended in various ways. From a methodology perspective, it becomes important to assess to what extent the documented rise in foreign-domiciled funds results from improvements in the reporting population. Of course, this is not to negate that the share of such funds has been objectively on the rise, but rather to obtain more precise estimates which could inform both policy (including nowcasting) and research work.[3] Related, given investment funds' assets under management are marked-to-market, it becomes important to asses to what extent the good correlation found between EPFR-sourced data and national data (such as that coming from the SNB) is an artefact of changes in the prices of the underlying securities. In addition, benchmarking the findings to those that can be obtained from other high-frequency sources of portfolio debt and equity data, such as those coming from the Institute of International Finance Portfolio Flows Tracker, should also be a fruitful exercise to undertake, not least to underscore the value added.

3 Similar fine-tuning would also benefit the ESG-related part of the analysis, as it is well-known and documented that so-called "green-washing" can be pervasive given that there is no universally accepted common definition of what is and is not ESG. This gives rise to self-labelling, which can impact measures like those of Schmidt and Yeşin.

From an economic perspective, this work opens to door to interesting future research. In particular, extending and refining the analysis of the impact of foreign-domiciled fund flows on domestic variables across countries and time should provide for interesting insights, potentially contributing to related work such as CONVERSE et al. (2021). This could also help shed light on the somewhat counterintuitive finding that foreign-domiciled fund flows have no effect on the exchange rate.

To sum up, the paper by Schmidt and Yeşin makes a valuable contribution to a growing body of work documenting the rising footprint of NBFIs. This can already help policy monitoring work, and if refined with future work, can also help better understand the cross-border impact of the rise of NBFIs on borrowing countries.

References

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