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Comments on Carry Trade Dynamics under Capital Controls

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Some context to paper's contribution

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- Very relevant paper:
- Helps to understand dynamics of capital flows in countries with capital controls
- Paper focuses on China in the time frame in which it attracted large amounts of hot money.
- The focus on commodity finance as a way to bypass capital controls is welcome
  - Previous studies have focused on over/under-invoicing of trade

What does paper really do?

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- Shows empirically that commodity finance has helped investors do carry trades operations in China.
- More precisely, the accumulation of copper stocks can be explained by the onshore offshore interest rate differential in China.
- Exchange rate expectations do not seem to play a role, as it should be for this investor behaviour to be classified as carry trade

Capital inflows/outflows

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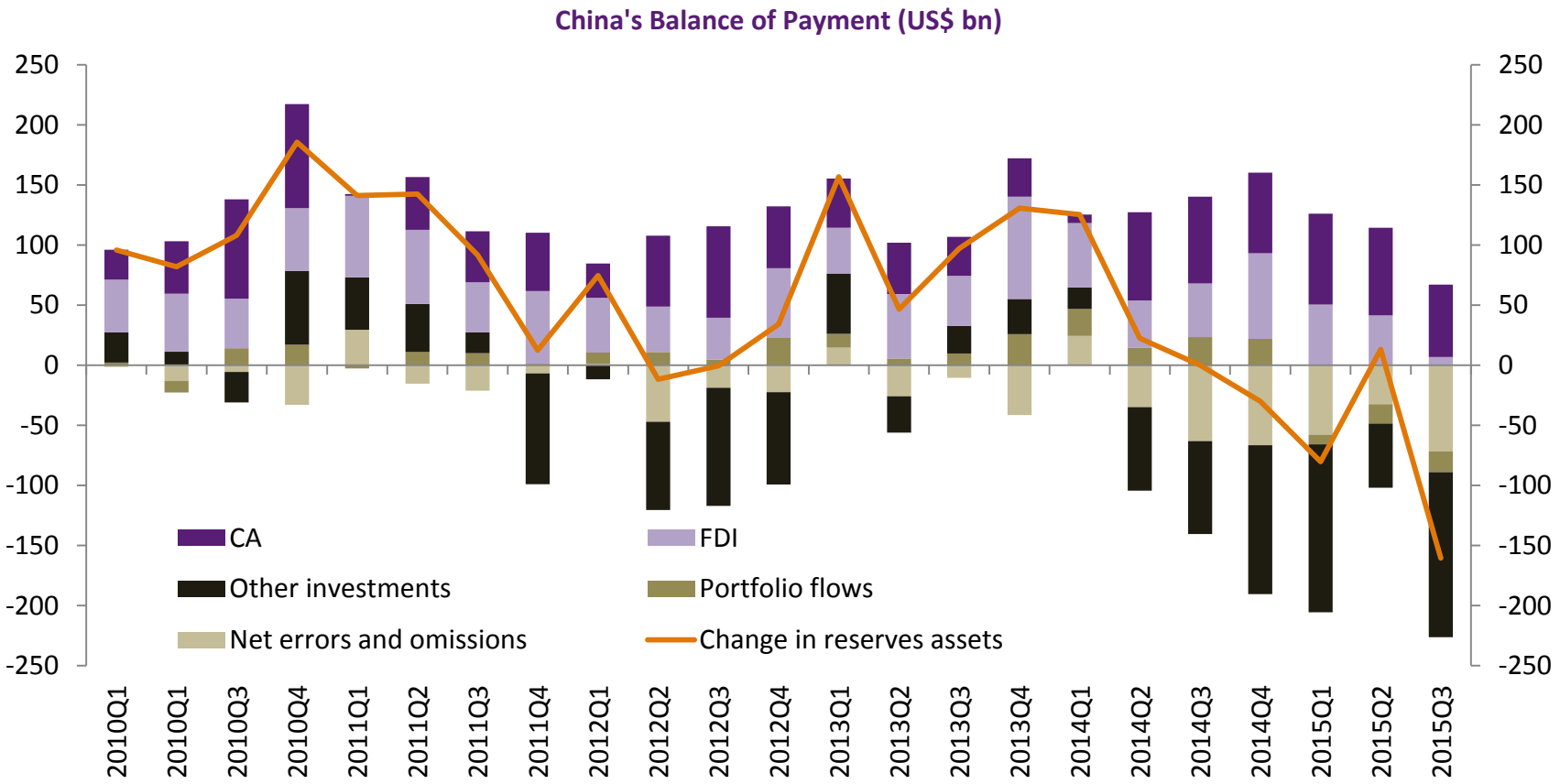
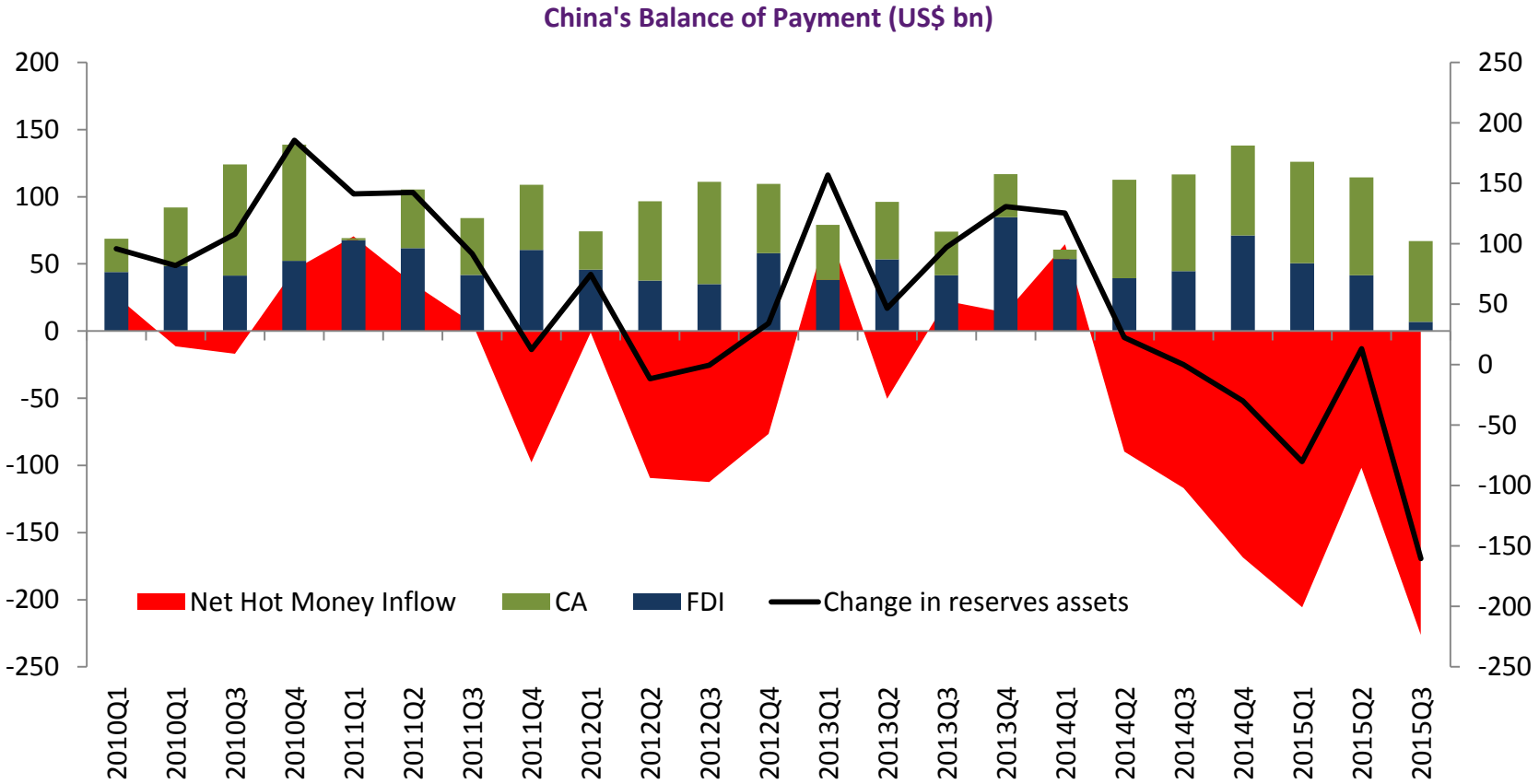
- The time frame covered in the paper is basically that of capital inflows.
- The authors make inferences as to how their results may be applied in the current phase of capital inflows.
- Namely that a reduction in the onshore-offshore differential should reduce the stock of copper onshore.
- Hard to see this in the data

Outflows are definitively large (recorded and unrecorded)



Source: Safe

Also hot money outflows following the paper definition



Source: Safe

Stock of copper should have fallen as onshore-offshore rates started to come down: True until August 2015 but not thereafter

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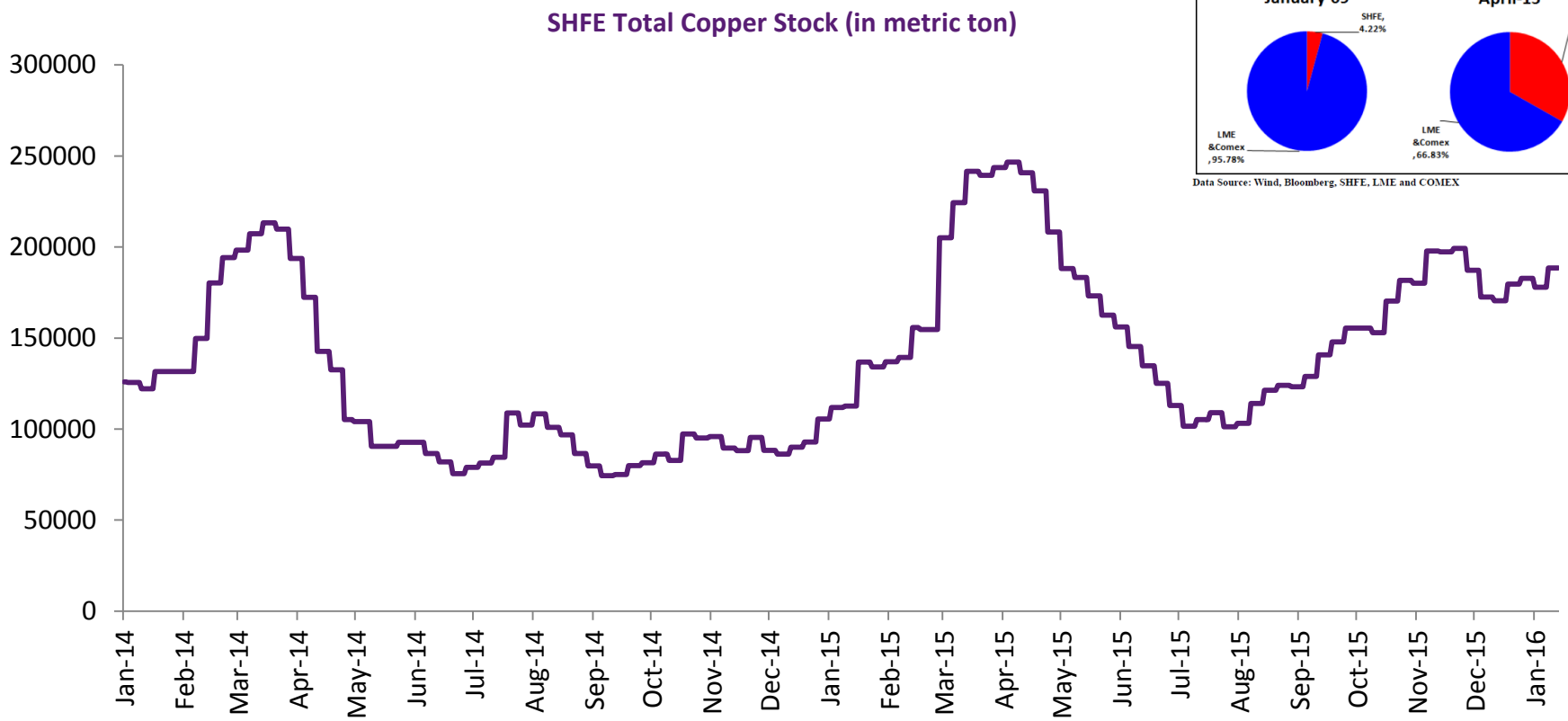
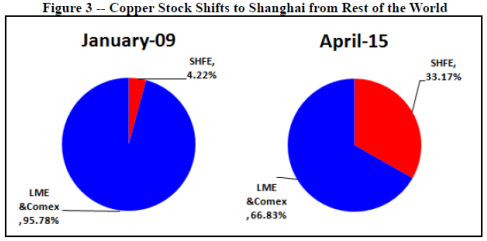


Figure 3 -- Copper Stock Shifts to Shanghai from Rest of the World



Data Source: Wind, Bloomberg, SHFE, LME and COMEX

Source: SHFE, NATIXIS

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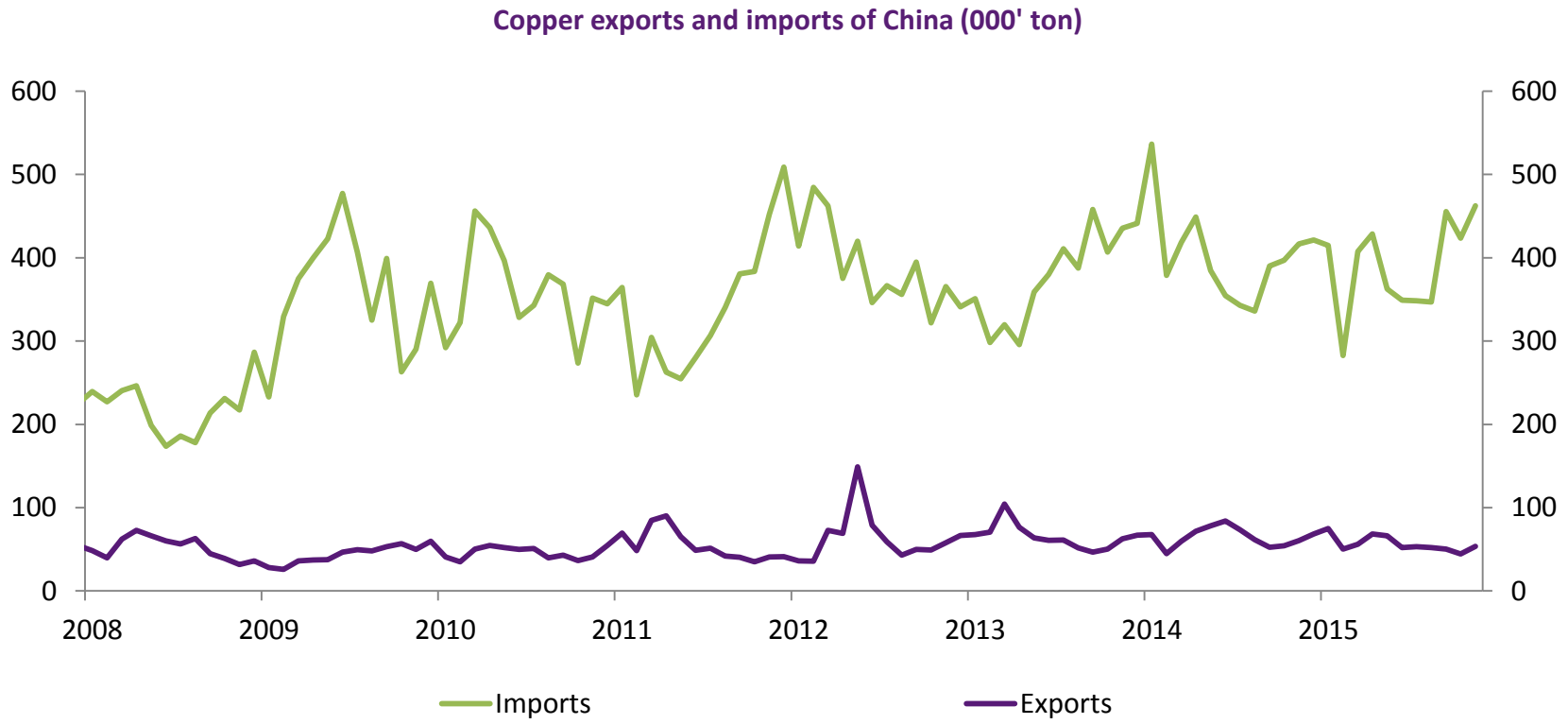
Copper exports have continued to increase Could the increasing copper stock be explained by strategic stocking profiting form the bargain prices?



Source: Bloomberg, NATIXIS
* Unwrought copper & copper products

Implications for the copper market

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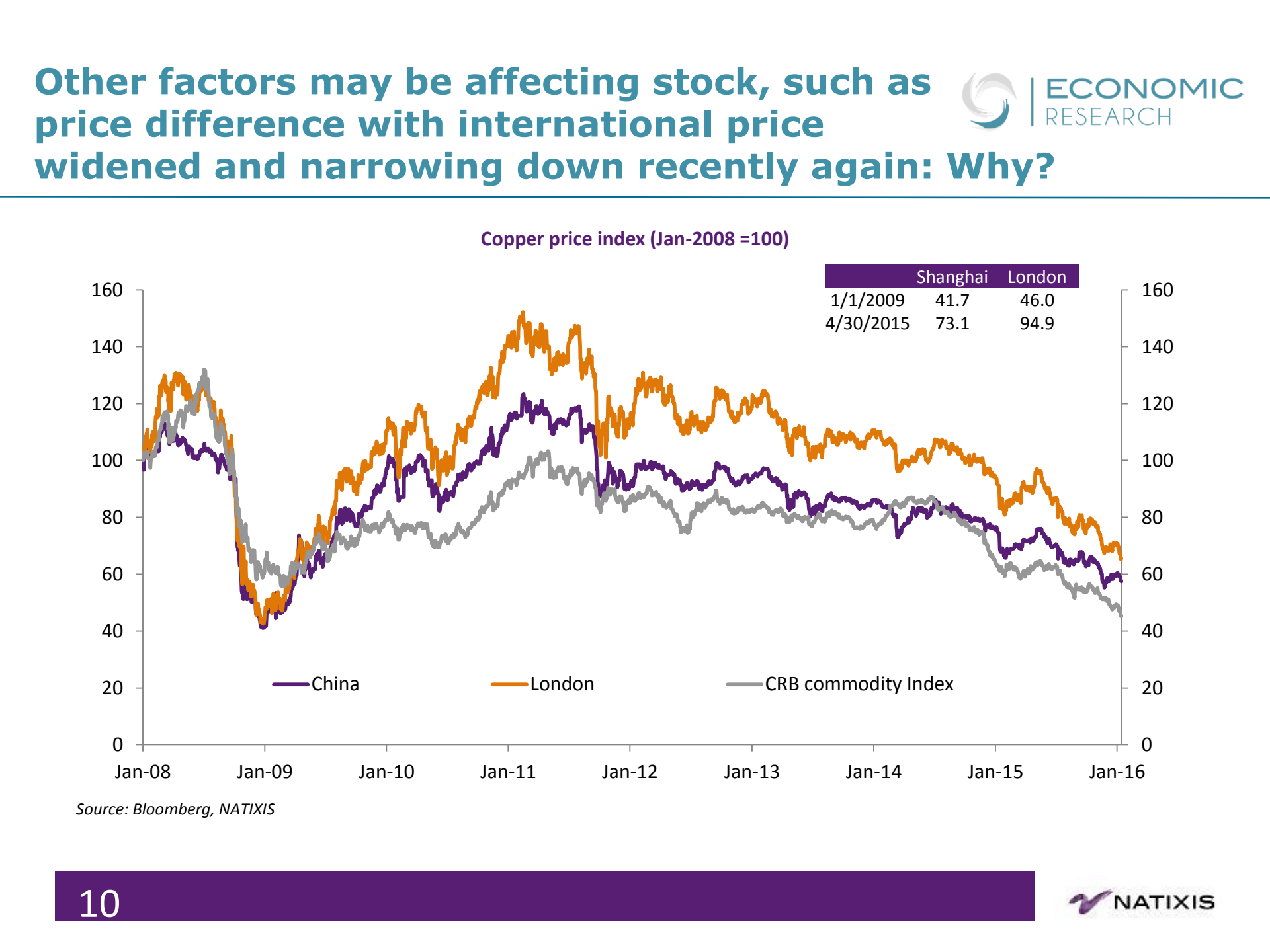
- Authors' estimate of the quantitative impact of the carry trade can be relevant for the analysis of the **copper market at a global level**
- To understand copper **price formation**, crucial to know how much of the price can be explained by speculative factors (such as carry trade) instead of real economy ones.
- The paper estimates that that impact of an increase in the onshore-offshore interest differential by 1 basis points should increase the stock of copper by $1.5million.
- Such differential has moved from about 400 bp positive in 2013 to 200 bp negative this January. The reduction in stocks should have been of $ 900 million but we have actually seen an increase

Other factors may be affecting stock, such as price difference with international price widened and narrowing down recently again: Why?



Source: Bloomberg, NATIXIS

Relative importance of different means to move money in and outside China

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- Overall, how important is commodity finance compared to over/under-invoicing of trade?
- Is commodity finance all recorded or unrecorded flows?

Over-invoicing activities

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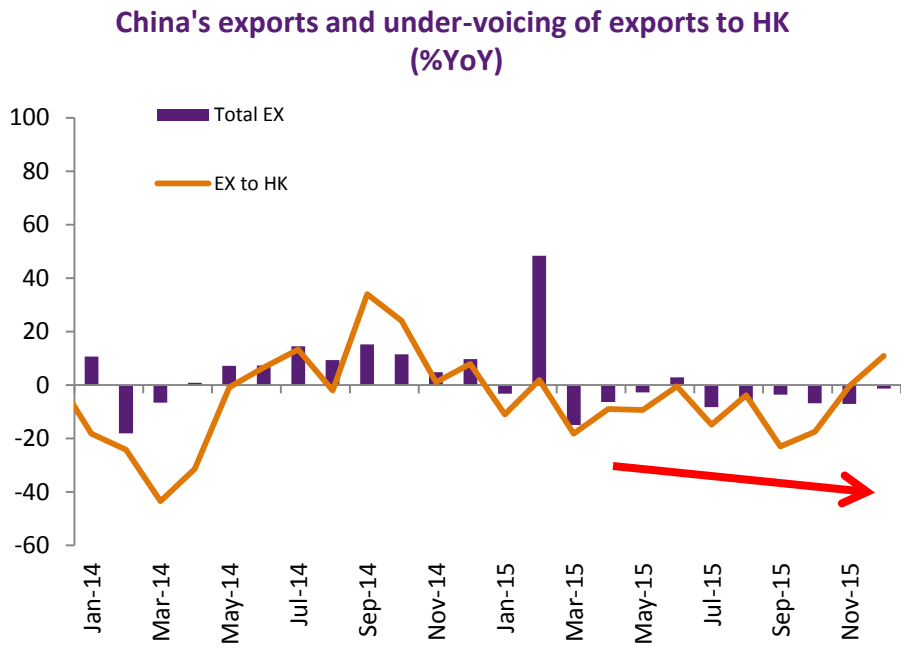
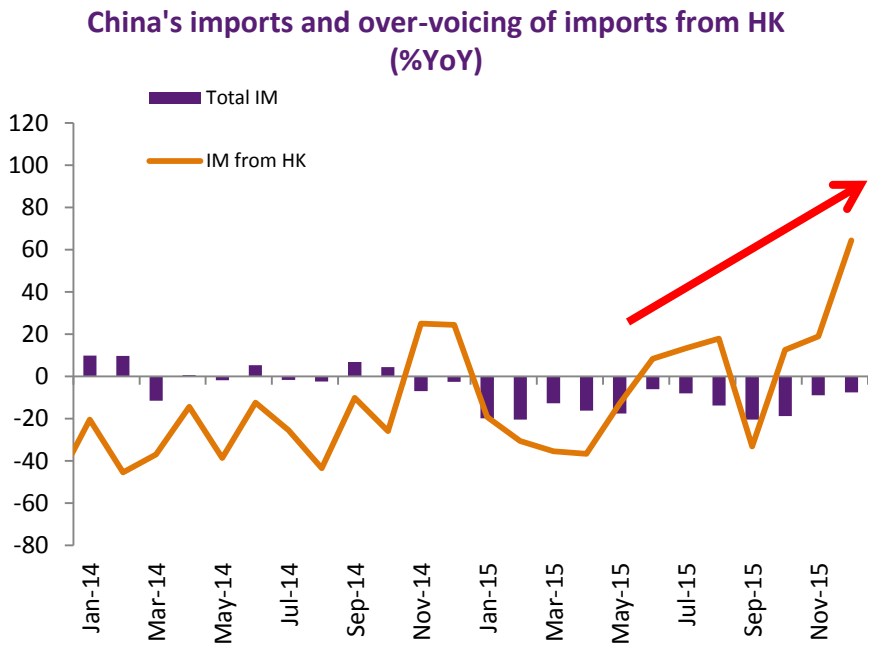


Source: Datastream, NATIXIS



Source: Datastream, NATIXIS

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All in all

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- This is a very good paper on an important topic.
- More research is needed on understanding how capital creeps in and out of China, especially in the current circumstances