US monetary policy, fund flows, and capital restrictions

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Introduction

- Empirical study of impact of monetary policy tightening on allocations of US mutual funds/ETFs to emerging markets stock and bond funds.
- Strong macro theory on the effect of policy interest rates on *net* capital flows.
  - Policy rates rise, net capital flows toward high interest rate economies.
  - Note this is a macroeconomic theory, not a portfolio theory, depends on real adjustments of saving and investment.
- Paper discusses the empirics of the interaction between long and short-run macro factors and gross inflows.

Initial Findings

- In weeks with an unexpected jump in 2 year US rates or a steepening of the yield curve over the 2-10 year, there is a significant reallocation of funds away from emerging market stocks and bonds.
- Countries with capital outflow controls experience smaller *equity* outflows in response to rate shocks at the two year horizon.
- Similar controls limit *bond* outflows in response to rate shocks at longer horizon.

Are capital controls a significant impediment on international capital reallocation.

- How much of bond funds are invested on-shore in EMs?
- Countries with capital outflow restrictions may be more likely to stabilize exchange rates in response to changes in Fed policy stance.
- Dynamic model might allow us to understand speed of adjustment.

Theory of Gross Portfolio Flows

- In equilibrium, intuitive theory of portfolio allocation puts little restriction on flows.

Prices can shift w/o any change in positions

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if prices adjust flexibly we need not see any change in allocations

Hard to develop theoretical intuition of what changes in allocations mean

- Formal theory of macro level determinants of gross flows or gross portfolio allocations still relatively undeveloped (see Devereux and Sutherland or Bachetta and van Wincoop for methodology).
- This data and method might be useful for thinking about Gabaix and Maggiori (QJE, 2015) which founds portfolio balance model on intermediary level risk.