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Collateral Consequences, Capital Flows, and Commodity Prices

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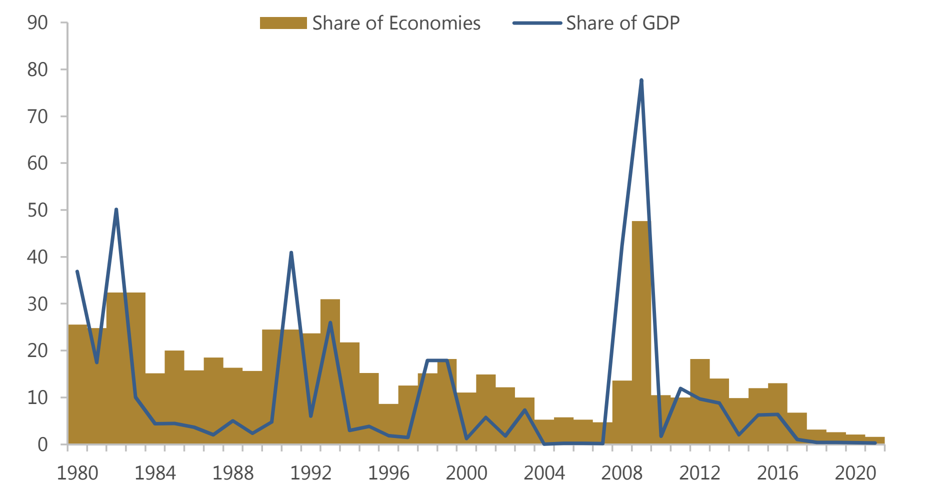
The trip to the extreme lower bound of nominal policy interest rates and experiments with other unconventional policies by the major central banks was designed to help at home. The collapse of asset prices, the locking shut of intermediation, and impairment of confidence threw a massive adverse hit to aggregate demand when, in many of these countries, fiscal policy was hamstrung. These monetary policy actions were not coordinated but emulated by officials dealing with circumstances on the ground. While all policy is local, it can have global consequences. Sometimes the best place to see this is by noticing an absence. In this case, notably absent is elevated distress in emerging-market sovereigns and domestic high-yield debt despite a confluence of adverse economic circumstances.

Economies In Recession Share of Countries and Global GDP, Percent



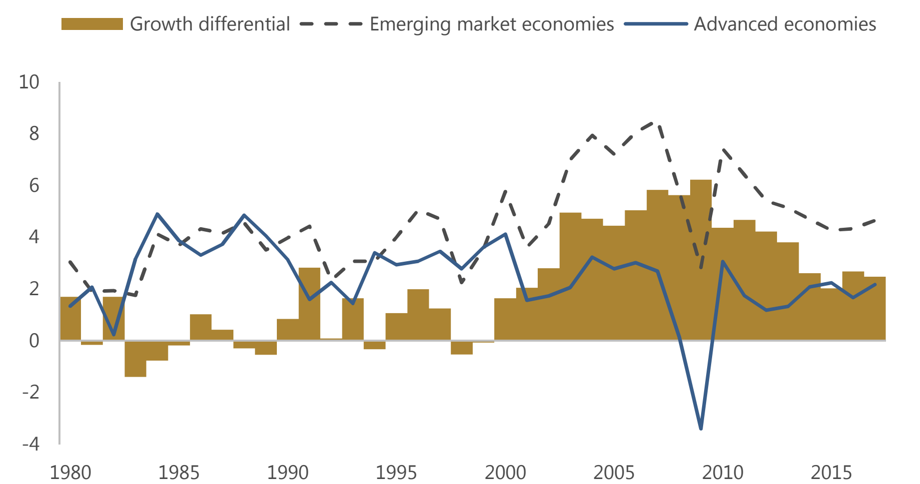
Source: IMF, World Economic Outlook (October 2017) and Standish calculations, accessed 11/13/17

This is what my coauthors (Carmen Reinhart and Christoph Trebesch) and I do in a paper presented earlier this month at the eighteenth annual research conference of the International Monetary Fund (available here). The title, "Capital Flow Cycles: A Long Global View," conveys the research strategy. We gathered data on as many countries as we could, both advanced and emerging market economies, back to 1815 on capital flows. We compared aggregate flows to an index of real commodity prices and the real short-term interest rate at financial centers, recognizing that the gravitational forces of global finance had multiple and shifting poles over two centuries. We also argue that the policy of the financial center should be judged in terms much broader than its real short-term interest rate. It takes about 85 pages (not counting the additional appendices) to work through data assembly and analysis but the core results—two recent anomalies about relative economic growth and finance—show through aggregates gotten from the latest World Economic Outlook of the International Monetary Fund over the relatively brief span since 1980.

The Great Recession of 2008 and 2009 earned its name, in that three-quarters of world real GDP (the line in the chart) was in the 50 percent of the economies that were contracting (the bars). This marks the peak in both measures over the nearly forty-year span shown. Output declined in advanced economies (the solid line in the next chart) and its growth was cut in half in emerging market economies (the dashed line). Still, the slowing in emerging market economies in percentage point terms was less than that in advanced economies (the bars), producing the widest growth gap between the two in the thirty year prior or since. Why was there so little collateral damage for such an event?

The pattern is even more challenging after considering the pattern of financial flows. The solid line in the next chart gives the sum of the absolute value of global current accounts relative to world nominal GDP. (Add up the pluses and minuses of current accounts in dollar terms, regardless of sign, and compare it to global nominal GDP.) Capital flows have been constricting since the Great Recession.

Advanced and Emerging-Market Economies: Real GDP Grow, Percent



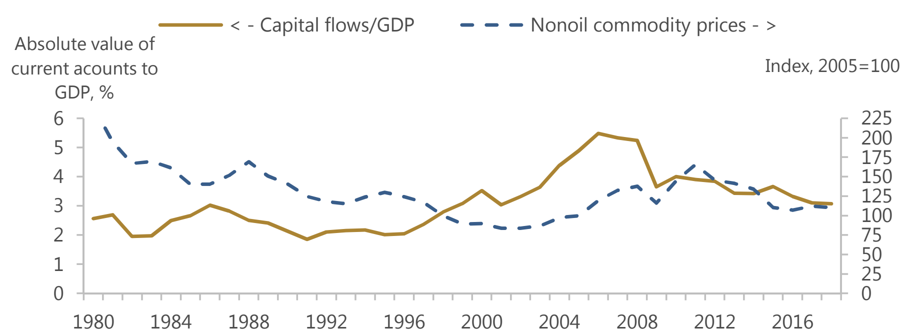
Source: IMF, World Economic Outlook (October 2017) and Standish calculations, accessed 11/13/17

This matters. The first two columns of the table provide recent peaks and troughs in capital flows a dated by a technique described in the paper and using a more encompassing measure of flows than the one in the chart. The dating goes back to the early 1800s in the IMF paper for the more adventurous, and the series in the chart conveys the same story and aligns well with the table dates. There are three distinct episodes in which global finance constricted—the early 1980s, the early 1990s, and post Great Recession.

Other cycles are at work, as well. The dashed line in the chart plots an index of real commodity prices, which follow a distinct downtrend over the sample. The rightmost columns of the table document the recent peaks and troughs in commodity prices, with four busts since the 1980s. This is a feature of the longer time series in the paper, as well, in that there are more commodity price cycles than capital flows cycles.

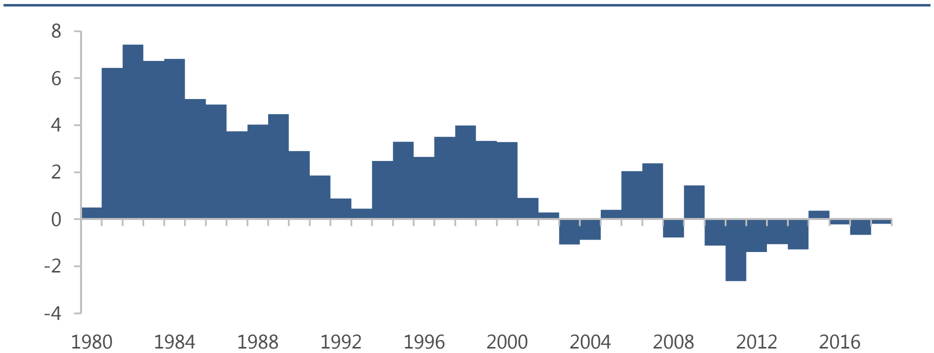
Our prime interest is in the overlap of the two sets of columns, or double busts in capital flows and commodity prices. They are relatively rare in the sample, with only eight significant and coincident declines in capital flows and real commodity prices since 1815. Telling about global finance, the six major spikes in new defaults over the period followed the end of a capital inflow bonanza. Double busts in capital flows in commodity prices and capital flows were associated with four of these six default peaks.

Capital Inflows and Real Commodity Prices, Percent and Index



Source: IMF, World Economic Outlook (October 2017) and Standish calculations, accessed 11/13/17

Real Short-Term Interest Rate, Percent



Note: Commodity prices are deflated by US consumer prices. Dates are taken from Table 2 capital flows and Table 5 for commodity prices of Reinhart, Reinhart, and Trebesch (2017) accessed 11/13/17

Despite this track record, sovereign defaults have not swelled. Equally surprising, high-yield borrowers in the US have kept up with payments, by and large, in the face of significant dislocations, notably in the energy sector. Presumably, the extraordinary efforts of central banks at financial centers to bolster flagging activity and impaired intermediaries had the subsidiary benefit of helping emerging market economies and the high-yield sector confronted with a sudden stop in capital flows and a bust in commodity prices. That is, the extraordinary low real short-term interest rate in the bottom panel acted as an important offset to cyclical effects. Time will tell whether unconventional monetary policy accommodation prevented a wave of defaults or postponed them. The test case comes as monetary policy resets, with the Fed first both with rate and balance sheet.

Recent Peaks and Troughs In Capital Flows and Commodity Prices

Capital Flows		Real Commodity Prices	
Peak	Trough	Peak	Trough
1981	1986	1977	1986
1991	1999	1988	1992
		1997	1999
2011	2016	2011	2016

Source: Reinhart, Reinhard, and Trebesch (2017), tables 2 and 5

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