Σrsa
Economic
Research
Southern
Africa

ERSA Research Brief
October 2015

Portfolio Flows in a two-country RBC model with financial intermediaries

Haakon Kavli and Nicola Viegi

Policy makers in emerging markets are increasingly preoccupied by the effect of global capital flows on the stability of their economy. Over the last decade, emerging markets have been battered by huge waves of capital inflows and outflows, seemingly unable to exert any control on their own economy. Commentators often argue that once a small economy opens to international financial market its policy is dictated by global factors at the expense of internal objectives. There is a large literature analysing the issue but few formal analysis that capture the link between global factors, capital flows and local economic conditions. Kavli and Viegi (2015) in the paper titled "Portfolio Flows in a two-country DSGE model with financial intermediaries" present a model to illustrate the effect of global capital flows on a small emerging economy and to help identifying the policy options available to an emerging market policy maker.

The model is an a reinterpretation of centre-periphery relationship classical in development literature, where the distinction between centre and periphery is now given by the risk profile of the assets generated in the two economies and the linkage between the two economies is given by a financial sector that intermediate portfolio flows. In this model, as it is argued in reality, portfolio flows are driven by global risk and they affect the real economy by expanding the bank balance sheet and the credit availability in the small emerging economy.

The results show that financial shocks can be absorbed by changing in the supply of risk free assets, as the experience of quantitative easing in industrialized countries has shown. Real shocks on the other hand can be absorbed by keeping the supply of financial assets fixed and instead allowing the prices to adjust to demand.

The model helps also in understanding the role of macro prudential policies, change in reserve requirements and other financial regulations that Central Banks are increasingly adding to their armour of instruments. The model shows that macroprudential regulation that limits the total risk exposure of the financial sector increases the volatility of portfolio flows, but reduces the volatility of consumption and labour and therefore increases welfare. Volatility in the composition of the balance sheet (portfolio flows), does not necessarily increase volatility in the aggregate size of the balance sheet (savings). Because the channel of transmission of portfolio flows to the economy is the banking system balance sheet, by imposing regulatory requirements the emerging country Central Bank can effectively protect the real economy from global financial cycles and re-acquire some level of control.