2017/12/14 貨幣與總體經濟研討會導讀
Are Asset price movements driven by international capital flows? The case of emerging markets

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1. What it the question?

   This paper examines whether richer countries attract more capital investments, a prediction of Neoclassical growth model. It also studies the relation between stock markets and international capital flows by observing the impulse response of stock prices to a "hot money" (transitory component of capital flows) shock in developing countries.

2. Why should we care about it?

   The large volatility of capital flows usually triggers booms and busts in asset markets, and it is also a nightmare for policy-makers. By digging into the factors that drive capital flows, we may have better understanding of optimal policies and more precise prediction toward the asset markets.

3. What is your answer?

   International capital inflows are decomposed into Foreign Direct Investment (FDI), Portfolio Investment (PI), and Other Investment (OI). The results show that FDI has positive correlation with income level of countries while PI and OI do not. The stock market prices are significantly associated with capital inflows. The results also indicate that the magnitude of the impulse response of real stock prices to a real hot money shock is significantly related to the income level and human capital index of countries.

4. How did you get there?

   The authors use the unobserved-component approach (Sarno and Taylor, 1999) to extract the hot money component from capital flows, and then employ a two-step factor-augmented VAR (FAVAR) model to obtain the impulse response.