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EDITORIAL

The Global Financial Cycle

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Recent research has suggested that there is a powerful global financial cycle whereby the monetary and financial conditions in major economies – most notably the USA – are transmitted to emerging market and developing countries. The existence of such a global financial cycle implies that there are externalities stemming from policy actions in the epicenters of the cycle. It also raises important questions about how the global cycle is transmitted and what policy actions might be taken to insulate economies from policies and market movements that originate in other parts of the world. To address these questions, researchers and policymakers gathered in Washington DC on November 2–3, 2017, at the IMF's 18th Jacques Polak Annual Research Conference. Our current issue features some of the papers presented at the conference with their key contributions summarized below.

The 2017 Mundell–Fleming lecture was delivered by Barry Eichengreen of the University of California, Berkeley. Foreshadowing the escalating trade tensions that would occur in 2018, Professor Eichengreen provides an assessment of whether a more restrictive trade policy might be good or bad for US growth. Based on evidence drawn from US economic history as well as empirical and theoretical studies, he argues that the short- and the long-run effects of trade restrictions are context-specific. In the short run, the effects of restrictive trade policies depend on how the revenues from trade taxes are redistributed, the reaction of the central bank, how long the policies are in place and how the gains and losses from the policy affect domestic versus foreign investors. In the long run, he argues, the balance of evidence points to a negative impact on the economy. Importantly, the kinds of arguments that supported trade protection by the USA in the past – to protect infant industries or to offset domestic distortions – are less persuasive today.

Eugenio Cerutti (IMF), Stijn Claessens (Bank for International Settlements) and Andrew Rose (University of California, Berkeley) directly confront the question:

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"How Important is the Global Financial Cycle? Evidence from Capital Flows." The authors assemble a comprehensive database that covers 85 countries, different types of capital flows and more than two decades of quarterly data. The study adopts two approaches for identifying the global financial cycle: the VIX, to capture time-varying changes in volatility in the largest financial markets, and a common global factor extracted from capital flows. They find limited evidence in support of a global financial cycle; the global component typically explains less than a quarter of the variation in observed cross-border flows, regardless of the type of capital flow or the measure used to define the global cycle.

"International Bank Flows and the Global Financial Cycle" by Mary Amiti (Federal Reserve Bank of New York), Patrick McGuire (Bank for International Settlements) and David Weinstein (Columbia University) conducts a similar analysis, narrowing the focus to the global component in cross-border banking flows. The evidence suggests that the importance of the global factor depends on the state of the global economy. In good times, they find that bank flows are well explained by a global factor. However, in crisis periods – namely the period following the global financial crisis – country- and bank-specific factors dominate the global factor. Their evidence suggests that the importance of the global financial cycle may be time-dependent.

The next paper provides a long-run perspective by analyzing data starting in 1870 across 17 advanced economies. In "Global Financial Cycles and Risk Premiums," Òscar Jordà (Federal Reserve Bank of San Francisco and the University of California, Davis), Moritz Schularick (University of Bonn), Alan Taylor (University of California, Davis) and Felix Ward (University of Bonn) argue that the comovement in credit, house prices and equity prices reached historical highs in the past few decades, supporting the view of a global financial cycle that has increased in importance over time. They find that comovement in equity prices surpassed real sector integration after 1990 and is largely driven by common market responses to US monetary policy. Countries with fixed exchange rate regimes experience stronger transmission effects of US monetary policy than those with flexible exchange rate regimes.

The exchange rate is an important mechanism through which changes in the financial centers are transmitted to the rest of the world. In "The Dollar Exchange Rate as Global Risk Factor: Evidence from Investment," Stefan Avdjiev (Bank for International Settlements), Valentina Bruno (American University), Catherine Koch (Bank for International Settlements) and Hyun Song Shin (Bank for International Settlements) examine the effect of dollar appreciation on investment in emerging markets. In particular, they study the "triangular" relationship between the strength of the US dollar, cross-border bank flows and real investment. Based on an analysis of macroeconomic as well as firm-level data in emerging markets, they establish that a stronger dollar is associated with weaker real investment and reduces dollar-denominated cross-border bank flows to those economies.

"Positive and Normative Implications of Liability Dollarization for Sudden Stops Models of Macroprudential Policy" by Enrique Mendoza and Eugenio Rjas (both University of Pennsylvania) examines the impact of changes in the *real* exchange rate on the supply of credit and the likelihood of a Sudden Stop. The model focuses on an economy in which intermediaries raise funds abroad in units of the traded

good (dollarized liabilities) but make loans in terms of the aggregate consumption good, comprised of traded and nontraded goods. The introduction of liability dollarization alters the probability of sudden stops – they are now milder – and the model is less likely to yield multiple equilibria. Liability dollarization also eliminates the rationale for capital controls as a tax on domestic debt in the decentralized equilibrium produces equivalent allocations to a tax on international borrowing.

The final paper in this issue estimates the global price of risk and examines how it changes over time ("Global Price of Risk and Stabilization Policies" by Tobias Adrian (IMF), Daniel Stackman (New York University) and Erik Vogt (Citadel)). The authors find that exposure to the global price of risk comes with a trade off: higher exposure is correlated with higher output growth as well as with higher output volatility. They also show that the transmission of the global price of risk to macroeconomic outcomes can be tempered through stabilization policies. Given the link between financial risk and macroeconomic outcomes, the authors argue that macroeconomic policies should not be considered separately from policies that affect the stability of financial markets.

We believe that this issue of the Review sheds light on many aspects of cross-border capital flows, the transmission of and response to global shocks, and exchange rate fluctuations. We hope that you will enjoy reading it.

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