# Discussion of "Corporate credit risk and capital flows in emerging market economies" by Tatjana Schulze

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# Credit risk and capital flows

- Does domestic corporate credit risk affect capital flows?
- Does a build up of corporate credit risk make EMEs vulnerable to reversals?

- Reverse causality → capital flows also affect credit spreads through availability of credit.
- Can we isolate pull factors from push factors in driving capital flows? This paper argues that firm size distribution can help through a granular IV approach.

- I have doubts about the validity of the instruments, BUT…
- This is a nice paper! Very creative approach & well-written. It should be included in any international finance syllabus.
- Most importantly, all issues and challenges are clearly acknowledged and discussed.

# Granular IV

- GIV: shifts in credit risk that is idiosyncratic to “large players” affect macro outcomes.
- Isolate idiosyncratic firm shocks by stripping out country-risk and global factors.
- If some firms are large enough, firm-specific risks cannot be diversified and hence it is systematic – it influences perceptions about economy-wide risk.
- It summarizes credit risk of particularly large firms not explained by the average firm.
  - For example, as long as sovereign risk affects all firms equally, it is fine.
  - That is a big if.

# EME-EBP and EBP of GZ

- Calculate an EME-EBP using this approach.
- Strong co-movement between the two pre-GFC.
  - Co-movement → a common factor drives both.
  - Post-GFC, co-movement declines, leaving room for other factors.
  - A natural question: How is this possible given the enormous impact of QE and the associated search for yield globally intensifying common global factors?
  - CGFS (2021) also finds a similar result in a very different setup using different data. This is encouraging.
  - BTW, why the drop during Covid?

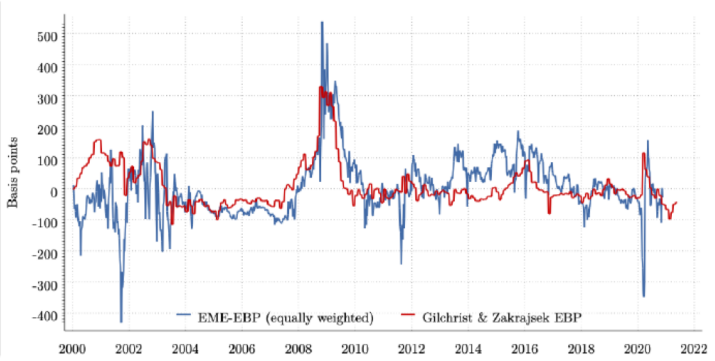


**Figure 5:** The Excess Bond Premium of Emerging Market Economies and the EBP of Gilchrist and Zakrajšek (2012).

Note: The excess bond premium (EBP) for emerging market economies is computed as the arithmetic average of residuals from the decomposition of the log of option-adjusted credit spreads (OAS) following closely the model in (6) and Gilchrist and Zakrajšek (2012). The EBP is based on an unbalanced panel of 27 EMEs. The EBP estimated by Gilchrist and Zakrajšek (2012) for the US is publicly available via the Federal Reserve. Countries include AE, AR, BR, CL, CN, CO, CZ, DO, HU, ID, IL, IN, KR, KZ, MX, MY, PE, PH, QA, RU, SA, SG, TH, TR, TW, VE, and ZA.

# Instrument validity: sovereign risk

- Du and Schreger (2021) show that there are linkages between sovereign and corporate risk:
  - Heterogeneity in private sector's FC exposure explains sovereign default risk across countries and time.
  - If the private sector has FC debt, sovereign takes into account the impact of LC inflation on the private sector even when it borrows more in LC.
  - Likely to take into account the indebtedness of larger firms (too-big-to-fail, too-big-to-debt-overhang).

- Du and Schreger argument is beyond state-owned companies.

- If sovereign risk is related to firm size distribution and doesn't affect all firms equally, the validity of the instrument is at risk.

# Instrument validity: Investor side and intermediaries

- What happens if investors buy and sell large firms' bonds only to generate proxy exposures to a country? OR similarly, wouldn't weights of firms in investor portfolios depend on firm size?
  - Shocks to investors will be measured as shocks to firms.
  - Bond funds report holdings – can check to see if this is the case.

- An unobserved but important confounding factor is the substitution in and out of bank loans and bonds. What is measured as shocks to larger firms can be shocks to foreign intermediaries that provide financing (eg syndicated loans) to firms.
  - Perhaps include the broad dollar index, UIP deviations or CIP deviations to account for intermediary constraint related push (or pipe) factors.

# Other issues

- Narrative: investors like credit spreads as long as they are not “excessive”.
  - In the static panel, can you not check if there is a cutoff after which the coefficient would turn negative?

- Gross vs net flows - paper uses net, but gross is important (acknowledged).