REM
RESEARCH IN
ECONOMICS AND
MATHEMATICS

**REM Newsletter 35/2022**
July 31, 2022
Editors: António Afonso, Filipe Oliveira, Teresa Garcia

https://rem.rc.iseg.ulisboa.pt/
https://twitter.com/ResearchRem
https://www.linkedin.com/company/researchrem
https://www.facebook.com/researchrem/
Phone: +351 213 925 912. e-mail: rem@iseg.ulisboa.pt

## The Latest REM Working Papers

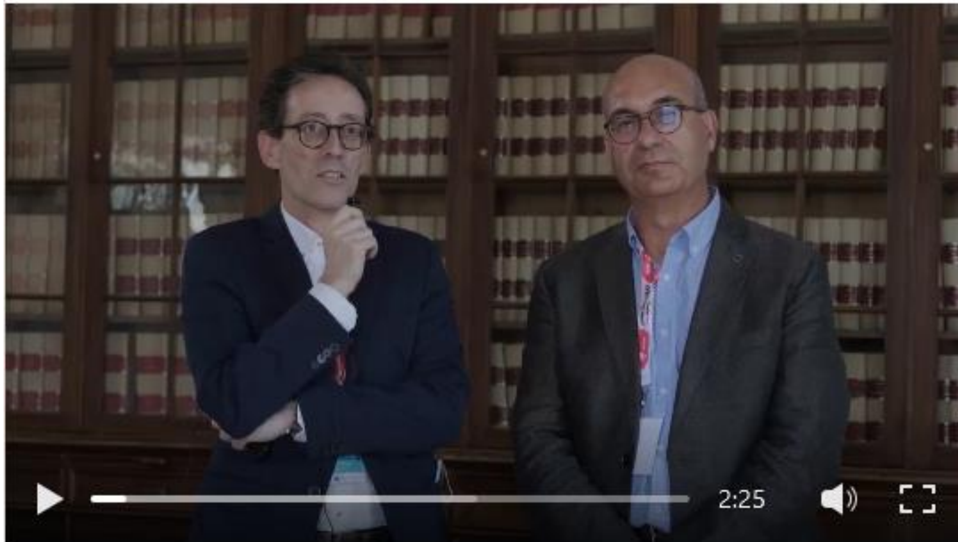
**Research in Economics and Mathematics** (REM) circulates research, notably by its affiliated members, as working papers intended for professional and public discussion and comment. The papers have not been peer reviewed.

**Table of contents**

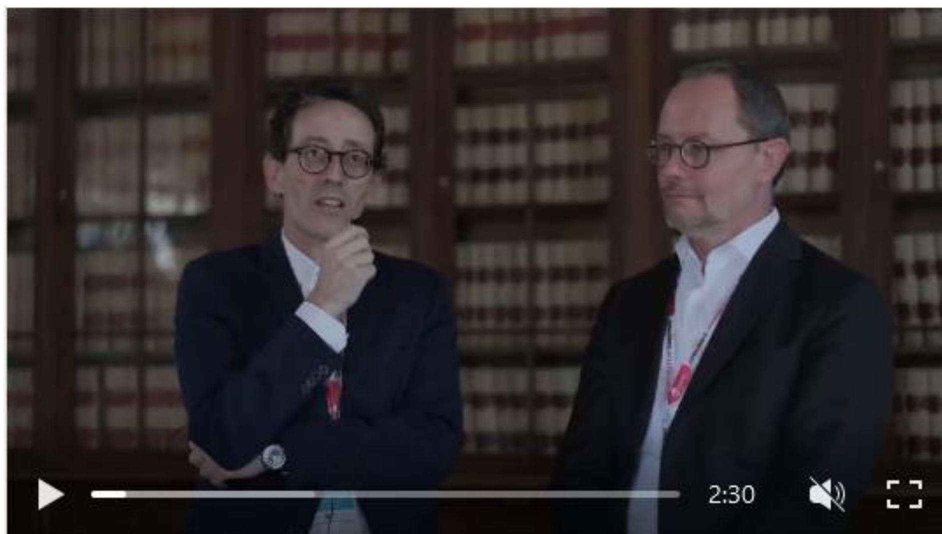
1. Revisiting the Determinants of Sovereign Bond Yield Volatility, Carlos Alberto Piscarreta Pinto Ferreira, *Working Paper 0241-2022*
2. Are Public Sector Banks in India a Government Failure? – A Comparative Empirical Analysis of Public Sector and Private Sector Banks in India, Sahil Chopra, *Working Paper 0240-2022*
3. Manipulating Credit: Government Popularity as Driver of Credit Cycles, Etienne Lepers, *Working Paper 0239-2022*
4. The Great Moderation and the Financial Cycle, Friedrich Lucke, *Working Paper 0238-2022*
5. Inflation Targeting and Private Domestic Investment in Developing Countries, Bao-We-Wal BAMBE, *Working Paper 0237-2022*
6. The role of wage bargaining institutions in the Phillips curve flattening, Francesco De Palma, Samuel Ligonnière, Jamel Saadaoui, Yann Thommen, *Working Paper 0236-2022*
7. Financial, Institutional, and Macroeconomic Determinants of Cross-Country Portfolio Equity Flows, António Afonso, José Alves, Krzysztof Beck, Karen Jackson, *Working Paper 0235-2022*
8. Investor Base Dynamics and Sovereign Bond Yield Volatility, Carlos Alberto Piscarreta Pinto Ferreira, *Working Paper 0234-2022*

**Events**

During the **10th UECE Conference on Economic and Financial Adjustments in Europe** (22nd July 2022) we had the pleasure of having a keynote address by **Cecilio Tamarit (University of Valencia**) with the title "External imbalances in turbulent times: a tale of three papers." Cecilio took the time to have a brief chat with António Afonso about the implications of the recent decisions made by the ECB:
https://www.linkedin.com/feed/update/urn:li:activity:6957316321285947392




In addition, **Xavier Debrun** **(National Bank of Belgium)** gave the keynote “Germs, War and the Policy Mix”. In addition, Xavier also took the time to talk with António Afonso about the new tools policymakers in the different member states have in order to control market expectations, and about the new monetary policy instruments of the ECB.
https://www.linkedin.com/feed/update/urn:li:activity:6957662019080585216




**REM Working Papers**

Revisiting the Determinants of Sovereign Bond Yield Volatility, Carlos Alberto Piscarreta Pinto Ferreira, *Working Paper 0241-2022*

Although there is an extensive literature regarding volatility in the financial markets, to our knowledge, few empirical studies specifically focus on the drivers of volatility of sovereign bond yields. This empirical paper aims to fill part of this gap and to provide more up to date empirical insights. We add to previous work by examining the issue simultaneously in a broad number of advanced economies. Our analysis shows that sovereign bond unconditional volatility exhibits mean-reversion and persistence. Bond yield volatility responds to proximate market movements and global risk. However, that response is found to be uneven across geographies, asymmetric in some cases and possibly time-varying. Macro and policy uncertainty impact depends on the specific uncertainty measures used and rarely is very meaningful.

Are Public Sector Banks in India a Government Failure? – A Comparative Empirical Analysis of Public Sector and Private Sector Banks in India, Sahil Chopra, *Working Paper 0240-2022*

To extend banking services to the Indian rural sector, an act was passed in 1976 and then in 1980 to nationalize the banks. Giving the name to such an approach as social banking. Banking sector in India, therefore, has been bifurcated into public sector, private sector banks, foreign banks, regional rural banks, urban cooperative banks and rural cooperative banks.

Many studies have assessed the performance of private and public sector banks. Such research has evaluated the performance of private and public sector banks by estimating bank-specific and macroeconomic parameters. However, not many quantitative literatures are available which have estimated the impact of ownership on bank performance by considering ownership as one of the bank-specific independent variables to evaluate the impact of ownership on bank profitability. This paper seeks to fill this gap by examining the determinants of profitability on the account of ownership, and it uses an independently constructed dataset containing all commercial public and private sector banks in India as on April 2020. The data ranges from 2004 to 2020. The justification to measure the impact of ownership comes from the theory of Government failure, which mainly points out how government intervention can result in costly solutions. Therefore, by adding the independent variable in an already established model, we can assess the impact of ownership.

Banks' characteristics are collected from respective banks' websites, and the hypotheses are tested by estimating an econometric model, i.e. a pooled OLS model.

The results are promising: the banking industry as a whole is not performing well, however government owned banks are showcasing the worst performances. The reason for this can be the huge amount of loans sanctioned in priority sectors and fraudulent cases which may be due to the presence of interest groups, corruption and inefficiency of employees in public sectors.

Manipulating Credit: Government Popularity as Driver of Credit Cycles, Etienne Lepers, *Working Paper 0239-2022*

This paper analyses the interaction between credit and political cycles, arguing that short-termist governments will seek to ride and amplify credit cycles for political gains. Specifically, it tests for the existence of political credit cycles not only before elections but throughout the term when executives seek to bolster support in periods of popularity drops. Compiling a unique database on government approval from opinion polls in 57 countries starting in 1980, it provides evidence that drops in popularity are systematically associated with larger future credit cycles, robust to a number of checks for confounding factors. Such credit manipulation appears to target credit to households specifically, is more prevalent in advanced, financialized, and indebted economies, and increases the likelihood of bad credit booms. Overall, this research points to the crucial importance of political cycles as drivers and sources of financial cycles and vulnerabilities.

The Great Moderation and the Financial Cycle, Friedrich Lucke, *Working Paper 0238-2022*

We show that the defining features of the Great Moderation were a shift from output volatility to medium term fluctuations and a shift in the origin of those fluctuations from the real to the financial sector. We discover a Granger-causal relationship by which financial cycles attenuate short-term business cycle fluctuations while they amplify longer-term fluctuations at the same time. As a result, financial shocks systematically drive medium-term output fluctuations whereas real shocks drive short-term output fluctuations. We use these results to argue that the Great Moderation and Great Recession both result from the same economic forces. On the theoretical front, we show that long-run risk is a critical ingredient of DSGE models with financial sectors that seek to replicate these shifts. Finally, we used this DSGE model to refine "good luck" and "good policy" hypothesis of the Great Moderation.

Inflation Targeting and Private Domestic Investment in Developing Countries, Bao-We-Wal BAMBE, *Working Paper 0237-2022*

This paper analyzes the effect of inflation targeting on private domestic investment in developing countries. Using propensity scores matching methods, thus mitigating traditional self-selection problems, we find that inflation targeting has led to a 2.05-2.53 percentage point increase in domestic investment in targeting countries compared to nontargeting ones. Estimates are economically meaningful and robust to various checks, notably sample changes, additional controls, alternative estimation methods, and falsification tests. A few heterogeneity features of the treatment effect are further highlighted, depending on some factors. Finally, we explore the main transmission channels and identify monetary policy credibility as the key driver of the regime's effectiveness.

The role of wage bargaining institutions in the Phillips curve flattening, Francesco De Palma, Samuel Ligonnière, Jamel Saadaoui, Yann Thommen, *Working Paper 0236-2022*

We investigate the role of collective wage bargaining institutions on the relationship between wage growth and unemployment, that is, the wage Phillips curve. Based on a labour market model with frictions and collective bargaining, we hypothesize that when the economy deteriorates, wages fall less in parts of the economy covered by collective wage agreements negotiated by trade unions at a centralized level than in economies with bargaining fully decentralized within companies. We move from theory to empirical analysis using regional NUTS-2 data from European countries, which show evidence that the wage Phillips curve flattens when unemployment is high — and gets steeper when the labor market is overheated —, in economies where the sectoral or cross-sectoral levels play a role in the collective wage bargaining. We also find that from a level of centralization intermediate between the company and the sector levels, the wage Phillips curve is twice as flat.

Financial, Institutional, and Macroeconomic Determinants of Cross-Country Portfolio Equity Flows, António Afonso, José Alves, Krzysztof Beck, Karen Jackson, *Working Paper 0235-2022*

We consider a new dataset that provides a description of the population of financial equity flows between developed countries from 2001 to 2018. We follow the standard practice of controlling for pull and push factors as well as gravity-style variables, while also accounting for the business cycle, public debt and sovereign ratings. Our key findings are as follows: (i) equity flows are more intense between countries at the same stage of the business cycle (ii) increased equity flows to countries with a relatively lower public debt deficit as a ratio of GDP (iii) financial and macroeconomic variables are important for big equity flows, while institutional variables are important for the small flows. Overall, this new dataset provides novel evidence on the importance of the business cycle, government debt and sovereign ratings scores.

Investor Base Dynamics and Sovereign Bond Yield Volatility, Carlos Alberto Piscarreta Pinto Ferreira, *Working Paper 0234-2022*

We assess the role of investor base dynamics in explaining sovereign bond yield volatility in a broad number of advanced economies, adding to previous work by investigating the role of both foreign and domestic non-official investors and using local projections to parsimoniously address endogeneity among variables. Our results show that buying and selling have differentiated impacts on volatility. Foreign investors contribute to increase bond yield volatility, mostly through net sales. Domestic investors' net purchases may help to shield the sovereign issuer against volatility even if their dampening effect is not instantaneously felt or indeed is only observable in the more crucial context of rising yields. The Euro Area, split in two groups of countries that do not respond uniformly to foreign net sales nor enjoy the same level of protection from domestic net purchases, seems vulnerable requiring, from a policy point of view, vigilance, and protection against fragmentation risks.