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What Leads Capital Flow?: Evidence from Korean Bond Market

The U.S. FRB has started preemptive normalization after prolonged quantitative easing. Central banks of other countries are still far behind the pace. Some emerging market countries like South Korea may face the challenges posed by the U.S. interest rate rising above theirs, raising worries about turbulent adjustments of their capital and foreign exchange market as well as the overall economy to the reversal. This study shows, however, that interest rate differential is not a significant driver of capital flow into South Korean bond market; rather, risk appetite, economic growth, and foreign reserves are in the short- or long-run. Underlying reasons include the followings: Despite decreases in or reversal of the interest rate differential, FX swap rates change in a way enough to compensate market participants for their losses due to the changes in the interest rate differentials. Private capital flows through leveraged arbitrage of banks declined, attesting to the effectiveness of the prudential measures such as ceilings on FX forward position of banks. International investors with the investment strategy of maximizing Sharpe ratio do not respond to the short-term changes in the yield spread only.