Changing patterns of capital flows
CGFS Report
July 1, 2021
In September 2019, the Committee on the Global Financial System (CGFS) established a Working Group (WG) on capital flows, to analyse:

(a) changing patterns in the composition and dynamics of capital flows,
(b) macroeconomic and, in particular, the financial stability implications of these changes.

The analysis is based on recent policy reports, academic literature, the WG’s roundtable discussions, its central bank survey, and own empirical analyses.

Outline of the report and this presentation

• Chapter 1: Trends since the Great Financial Crisis (GFC)
• Chapter 2: Drivers of gross capital inflows and sudden stops
• Chapter 3: Benefits and risks
• Chapter 4: Policy tools and lessons
Trends of capital flows since the GFC

- Capital flows throughout the world increased rapidly between 2002 and 2007, when they totaled 12 trillions of USD (22% of global GDP). These flows diminished abruptly during the GFC and recovered afterwards without reaching the pre-GFC levels.
- **Emerging Markets (EMEs) flows** have held up relatively well post GFC (China in particular); flows to Advanced Economies (AE) remained below pre-GFC levels.
**Trends of capital flows since the GFC**

- **Change in composition:** increasing share flows through *portfolio* investors rather than banks.

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**Banks’ declining role**

*As a percentage of total external debt*

<table>
<thead>
<tr>
<th>Advanced economies</th>
<th>Emerging market economies</th>
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<tbody>
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<td>04</td>
<td>16</td>
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<td>07</td>
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<td>10</td>
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• EME flows have held up well post GFC (China in particular).

• More local currency issuance by EMEs sovereigns.

• Foreign investors participation in local debt markets has been shrinking since 2014.

• In regards to volatility of capital flows, some consider it decreased post GFC. However, the central banks’ survey shows that most participants believe volatility has increased.

• Less stable nature of foreign direct investment (FDI), mostly reflecting activity by multi-nationals.

AEs = Advanced economies; EMEs = Emerging economies; Financial centres = Hong Kong SAR y Singapur; Emerging Asia = CN, IN, ID, MY, PK, PH, TH; Emerging Europe = CZ, HU, PL, RO, RU, TR; Latin America = AR, BR, CL, CO, MX, PE; Middle East and Africa = EG, SA, KW, QA, ZA.

Fuentes: FMI, Balance of Payment Statistics; cálculos del CGFS Working Group
Drivers of capital flows

Global push factors

- Shifts in the risk appetite have been an important driver of capital flows to EMEs.
- Marginal changes in unprecedented levels of global liquidity (proxied by AE monetary policy) have had only a limited effect on the capital inflows.
- Significant changes in global liquidity can trigger sudden stops (e.g., Taper Tantrum).

Sudden stops: share of affected countries

In per cent

![Graph showing the share of affected countries over time, with lines for Forbes and Warnock (2019) and Yesin (2015).]
### Drivers of capital flows

- **Pull factors**
  - Good local **fundamentals** can reduce the likelihood of a sudden stop.
  - Institutions less important (as many EMEs “graduated”).
  - Participants in WG roundtables with private sector asset managers pointed out that their investment decisions have been shifting towards differentiation at the country level from broad asset classes of country types.

![Core drivers of capital flows as indicated in the survey](image)

1. AEIs: AU, BE, CA, CH, DE, EA, ES, FR, GB, IT, JP, LU, NL, NZ, SE, and US.
2. EMEs: AR, BR, CN, CL, CO, HK, IN, KR, MX, MY, PE, PH, RU, SA, SG, TH, TR, and ZA.

Source: CGFS Working Group, Survey on changing patterns of capital flows, August 2020, questions 6a and 7.
Drivers of capital flows

**Pipes**

- More local currency issuance by EMEs sovereigns, but USD generally remains dominant.
  - The investors base became more diversified and local financial markets developed, fostering the issuance of debt in local currency by governments.
  - Investment strategies based on index bonds or index equities can exacerbate herd behavior and contagion across economies.
- Less stable nature of FDI, mostly reflecting activity by multi-nationals.

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**Index inclusion and capital flows**

Percentage of central banks that answered "yes"  

<table>
<thead>
<tr>
<th>Does index inclusion matter for the dynamics of capital flows?</th>
<th>Does index inclusion matter for central bank policy making?</th>
<th>Is the effect different for private and government securities?</th>
</tr>
</thead>
<tbody>
<tr>
<td>AEs</td>
<td>EMEs</td>
<td>AEs</td>
</tr>
</tbody>
</table>

Source: CGFS Working Group, Survey on changing patterns of capital flows, August 2020, question 8b, 8d, and 8f.
Benefits and risks from capital flows

- More definite conclusions on **benefits** than in the 2009 CGFS report, partly based on more data and identification techniques.
- Both AEs and EMEs highlight **real** and **financial** benefits in the survey.
- Having foreigners buying local currency debt can increase the **sensitivity** of local financial conditions to shocks originating abroad.

Survey: Describe the main benefits related to capital flows

<table>
<thead>
<tr>
<th>Expand productive capacity and growth rate of output</th>
<th>Risk sharing by diversification of savings</th>
<th>Higher returns on savings abroad, enhanced profitability</th>
</tr>
</thead>
<tbody>
<tr>
<td>AEs</td>
<td>EMEs</td>
<td>AEs</td>
</tr>
<tr>
<td>Yes</td>
<td>No or no response</td>
<td>Yes</td>
</tr>
<tr>
<td>Percentage of countries within each group</td>
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Foreign participation in local bond markets and sensitivity to global risk

1 Sensitivity is measured by the slope coefficient of a linear regression of monthly changes in 10-year local currency sovereign bond yields on log changes in the VIX index.

Sources: Survey of central banks; Federal Reserve Economic Data (FRED); Bloomberg; CGFS Working Group calculations.
• Type dependent benefits from capital flows exist, despite of volatility:
  • **Bank flows** increase funding for local firms, which increases investment, productivity and economic growth, even if they are volatile.
  • **Portfolio flows** associated with issues in local equity markets also increase the sources of funding for investment.
• Risks from capital flows can be classified into three categories:
  • **Misallocation** of resources across sectors.
  • **FX exchange** effects on financial stability and real activity.
  • **Sudden stops**.

**Benefits and risks from capital flows**

Which are the main channels through which the exchange rate affects the economy?

Average scale (1=not relevant, 5=very relevant)

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**Benefit: Bank flows**
- Increase funding for local firms
- Increase investment
- Increase productivity
- Increase economic growth

**Benefit: Portfolio flows**
- Increase sources of funding for investment

**Risks:**
- Misallocation of resources across sectors
- FX exchange effects on financial stability and real activity
- Sudden stops

Policy issues and lessons

Key conclusions

I. Policies that address short-term vulnerabilities are no substitute for long-term reforms.
II. There is no “one size fits all” prescription.
III. International cooperation remains key.

Against the backdrop of recent trends and underlying drivers of capital flows, the Covid-19 crisis illustrates how policy responded to materializing risks.
I. Policies that address short-term vulnerabilities are no substitutes for long-term reforms.

Long-term policies aimed at enhancing the **resilience** of the economy and financial system, and fostering an **efficient allocation** of resources.

Maximize benefits of capital flows while limiting associated risks.

1. Monetary policy
2. Microprudential
3. Macroprudential
4. **Capital Flow Management**
5. FX Intervention
6. Global Financial Safety Net

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**Policies**

1. **Definition and purpose**
2. **Benefits, costs & side effects**
3. **Character pre-emptive / reactive**
4. **Effectiveness**
5. **Interactions with other policy tools**
II. There is no “one-size-fits-all” prescription

1. **Definition and purpose:** explicitly designed to limit capital flows and reduce domestic financial risks.

2. **Benefits**
   + Reduce build-up of financial vulnerabilities
   + Manage composition and size of flows

   **Side effects**
   - Deflect inflows
   - Difficult to communicate
   - Sticky

3. **Character**
   Pre-emptive or reactive, by taxing inflows or restricting outflows

4. **Effectiveness:** mixed views
   AE: not effective
   EMEs: below 50% think they are effective.
   Many CBs prefer Macroprudential Measures (MPMs).

5. **Interactions with other policy tools**
   In combination with FX intervention or macroprudential tools, it can strengthen monetary policy autonomy.
II. There is no “one-size-fits-all” prescription

- **MPMs most effective** to complement other policy tools.

- **Impossible trinity**: small open economies often use a combination of CFMs, MPMs, FX intervention to strengthen monetary policy autonomy.

- **IMF Integrated Policy Framework** that jointly considers role of monetary policy, FX intervention, MPMs and CFMs is a significant contribution.

Optimal policy combination depends on nature of the shock and circumstances of each country.

Policy issues and lessons

- **Coordination.** Who decides, who implements policies?

- **Communication.** How to communicate multiple objectives related to a mix of policy tools?

- Can models provide useful insights for reality?

- How to identify shocks that inform the design of policies?
III. International cooperation remains key

1) The **pipes** channelling capital are **interconnected** and operate globally.

2) Local policy actions affecting these pipes have **global implications**.

3) Critical role of the GFSN in preventing and mitigating the effects of crises

   - International reserves
   - Regional Financing Arrangements
   - Swap lines
   - Repo facilities
   - IMF Lending Facilities
The Covid-19 crisis illustrates how policy responded to materializing risks

COVID-19 shock

EMEs record outflows
AEs dash for cash

Policy tools

Aggressive countercyclical response

Capital flows rebound

Push: Global risk aversion accentuated volatility.

Pull factors: countries with weaker fundamentals were most affected.

Pipes: Pro-cyclical behavior of NBFIs, contagious outflows and volatility, eg triggered by index tracking.

AEs: sharply reduced interest rates, APPs, FLS, special liquidity facilities.

EMEs: similar to AEs+ FX intervention

GFSN: Swap lines and repo facilities eased funding pressures. Some countries accessed IMF programs.

Turnaround benefitting from risk appetite given loose global financial conditions and optimism about vaccine developments.
<table>
<thead>
<tr>
<th>Tool</th>
<th>Benefits &amp; side effects</th>
<th>Character pre-emptive/reactive</th>
<th>Effectiveness</th>
<th>Interactions</th>
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<tbody>
<tr>
<td>Monetary Policy</td>
<td>+Primary tool to foster price stability, affect financial conditions and economic cycle -Applies at an aggregate level.</td>
<td>P: reduce inflationary pressures. R: support exchange rate</td>
<td>Central Banks prefer not to use monetary policy to address capital flows.</td>
<td>Interacts with FX policy (mainly in EM).</td>
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<tr>
<td>Micro-prudential</td>
<td>+Enhances resilience of individual institutions. - Incentivizes expansion abroad.</td>
<td>Pre-emptive</td>
<td>Effective for mitigating excessive volatility from credit growth. Most effective to complement other policies.</td>
<td>Strengthens other structural policies.</td>
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<tr>
<td>Macro prudential</td>
<td>+Target specific sectors of financial system, control excessive foreign currency lending, and rapid credit expansion -Suboptimal allocation of resources, stunt market development, growth of non-bank credit.</td>
<td>Pre-emptive</td>
<td>Depends on adequate execution and communication, consistency with other objectives.</td>
<td>Complements FX and CFMs.</td>
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<td>FX Intervention</td>
<td>+ Restore market functioning, prevent extreme movements feeding into inflation -Impairs FX market development, misalignment of exchange rate.</td>
<td>P: Reserve accumulation R: restore market functioning.</td>
<td>Strengthens monetary policy autonomy.</td>
<td>Strengthens structural policies, facilitates economic adjustment.</td>
</tr>
<tr>
<td>GFSN</td>
<td>+Financial support to prevent crisis or mitigate its effects. - Debate on whether GFSN is strong enough.</td>
<td>P: buildup of reserves, FCL, swap lines, RFAs. R: IMF programs</td>
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