Changing patterns of capital flows

CGFS Report

July 1, 2021

BANCO DE MÉXICO

Introduction

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

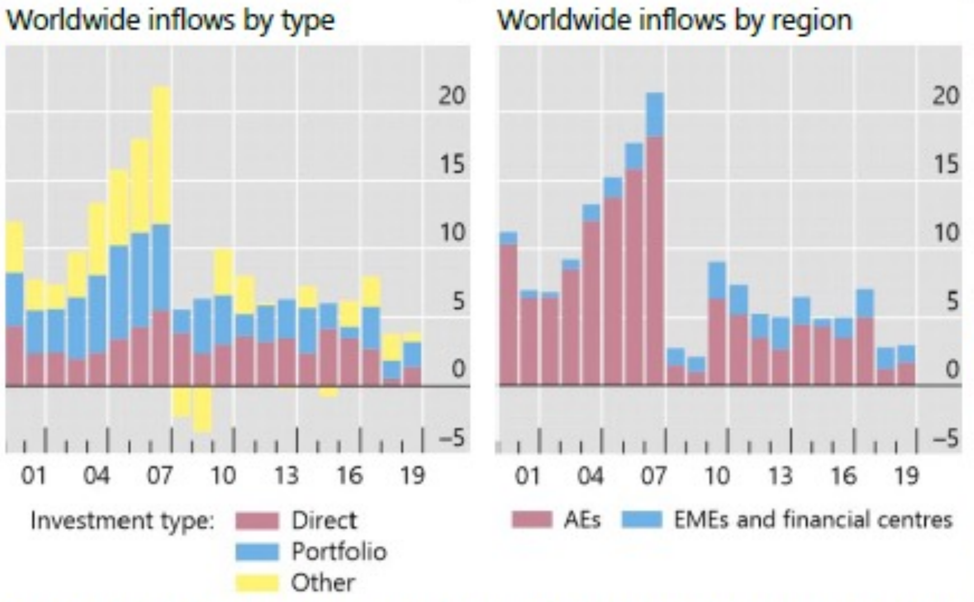
- Chapter 1: Trends since the Great Financial Crisis (GFC)
- Chapter 2: Drivers of gross capital inflows and sudden stops
- Chapter 3: Benefits and risks
- Chapter 4: Policy tools and lessons

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.

Capital flows by type and region

As a percentage of world GDP



AEs = advanced economies; EMEs = emerging markets; Financial centres = Hong Kong SAR and Singapore; 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.

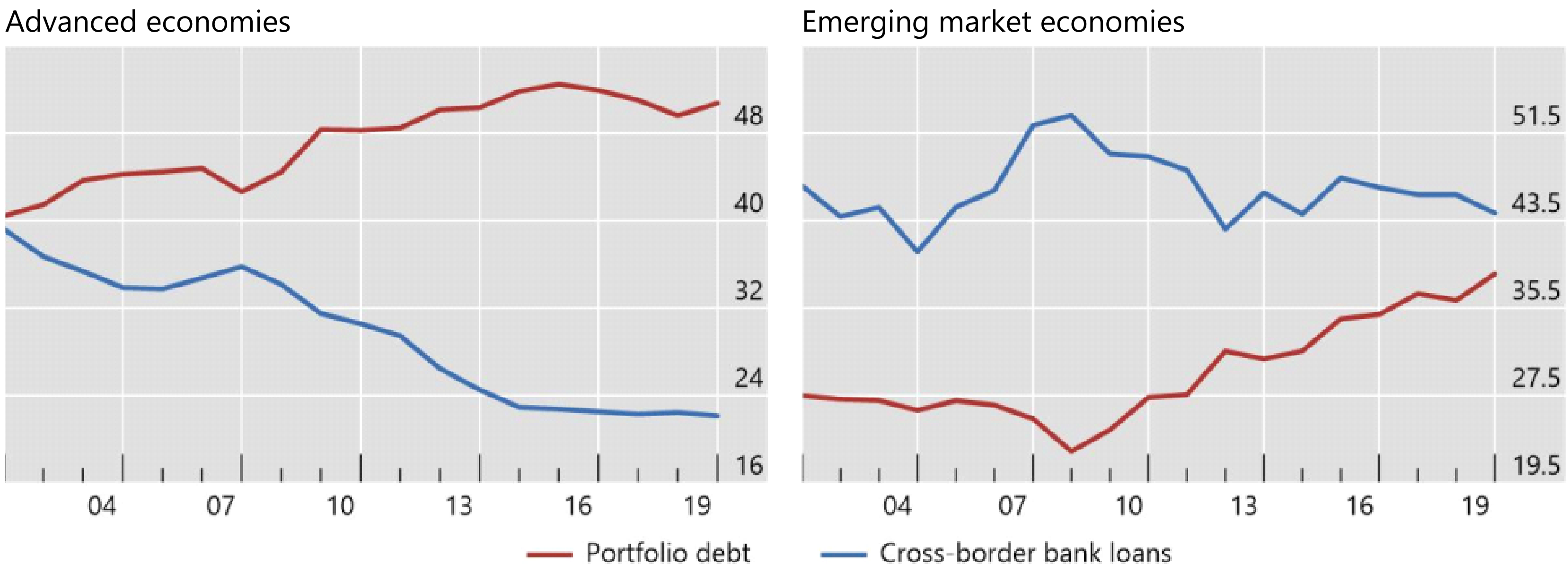
Sources: IMF, *Balance of Payment Statistics*; CGFS Working Group calculations.

Trends of capital flows since the GFC

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

Banks' declining role

As a percentage of total external debt



Sources: IMF, *International Investment Position Statistics*; IMF, *World Economic Outlook*; BIS locational banking statistics (by residence); CGFS Working Group calculations.

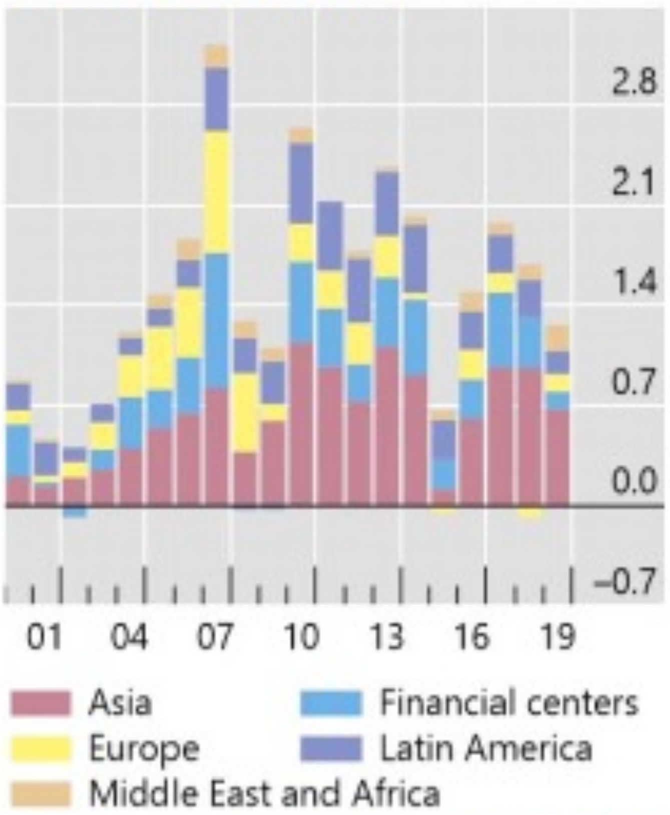
Trends of capital flows since the GFC

- 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.

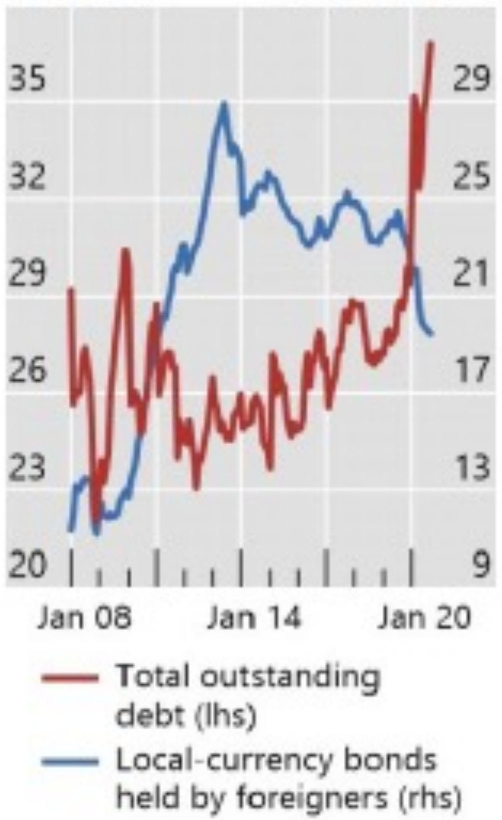
Capital flows by type and region

As a percentage of world GDP

Inflows to EME regions



Total EM debt in local currency is growing while non-residents' share is falling



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

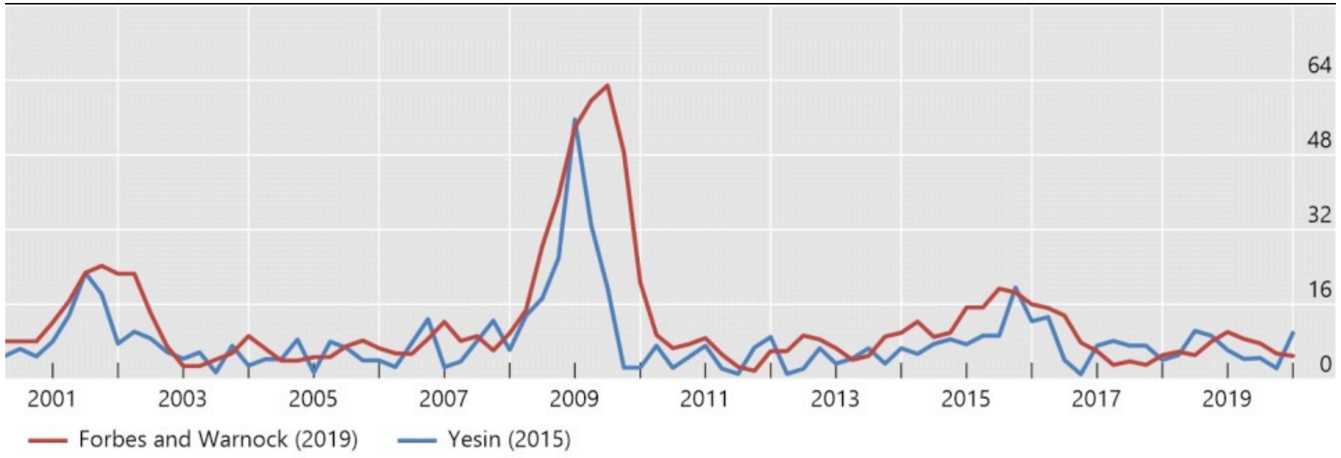
Drivers of capital flows

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 (eg Taper Tantrum).

Sudden stops: share of affected countries

In per cent

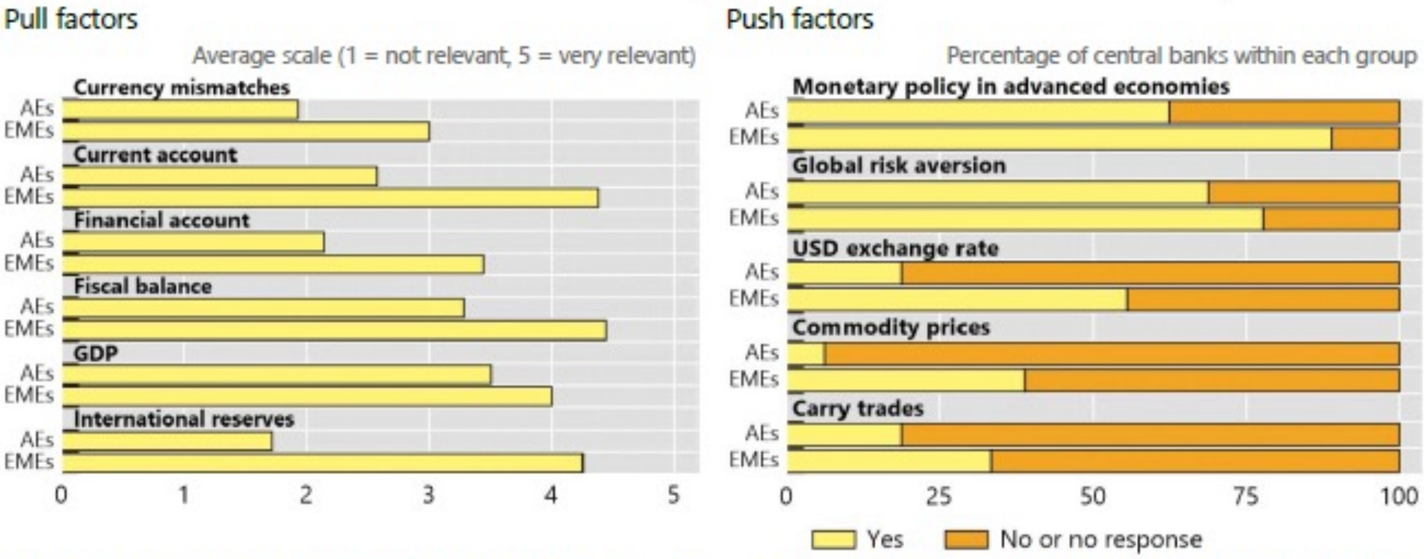


Drivers of capital flows

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[1,2]



[1] AEs: 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.

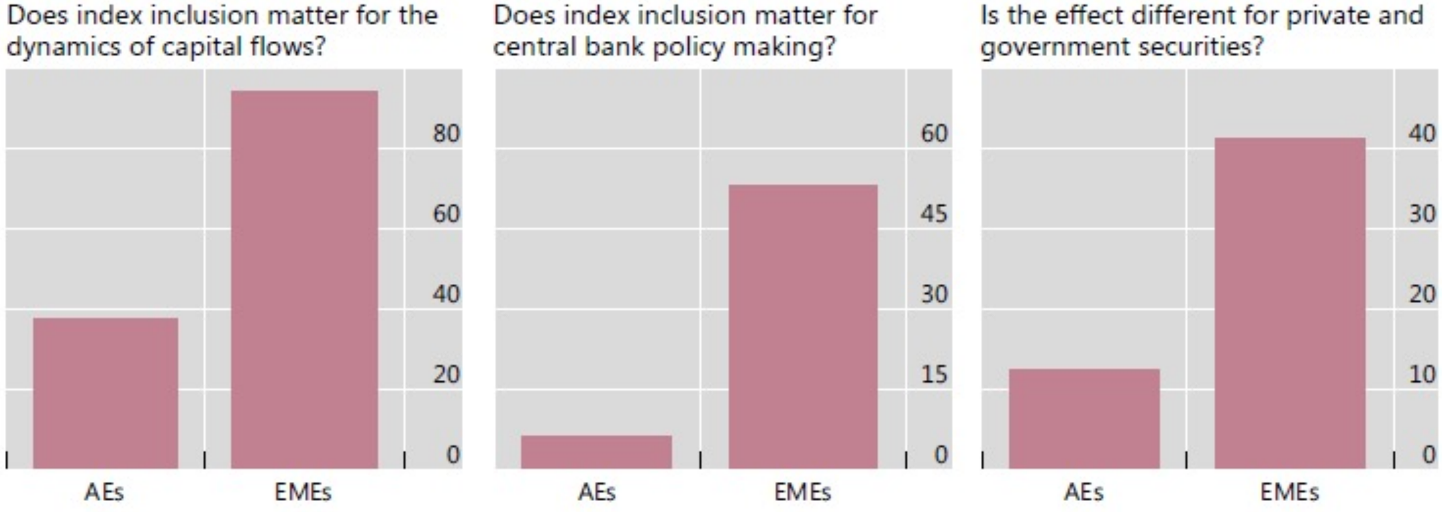
Drivers of capital flows

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.

Index inclusion and capital flows

Percentage of central banks that answered "yes" — Graph B9

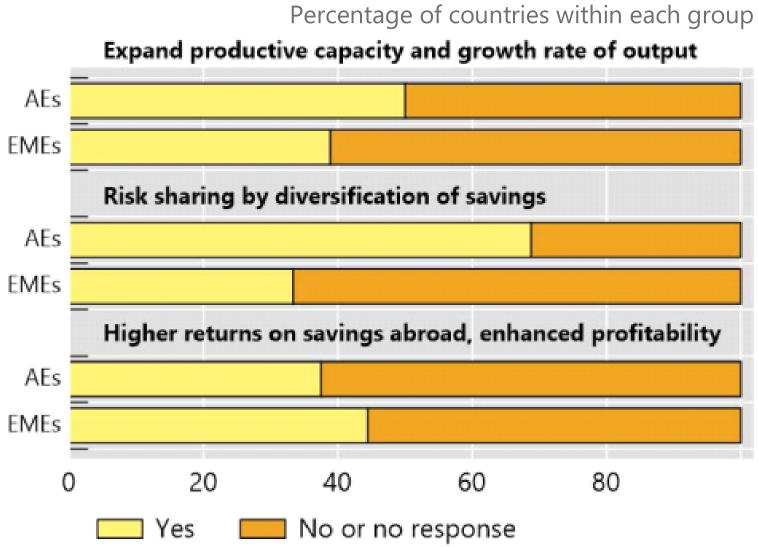


Source: CGFS Working Group, Survey on changing patterns of capital flows, August 2020, question 8b, 8d, and 8f.

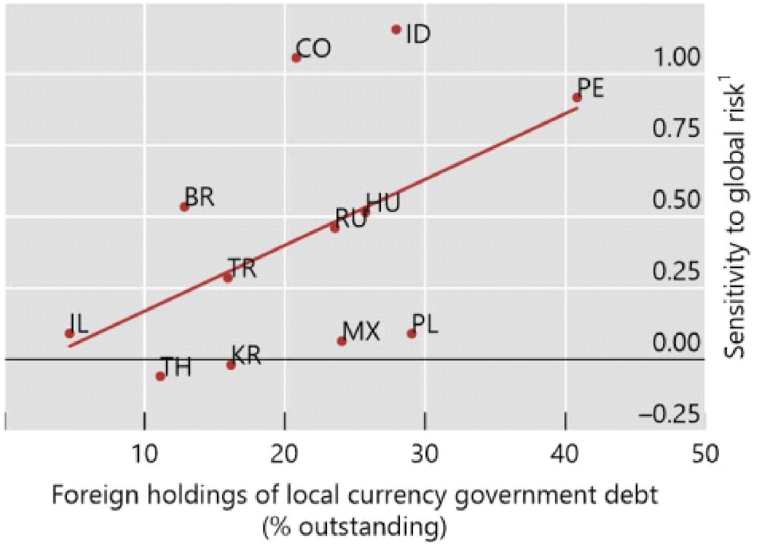
Benefits and risks from capital flows

- 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



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.

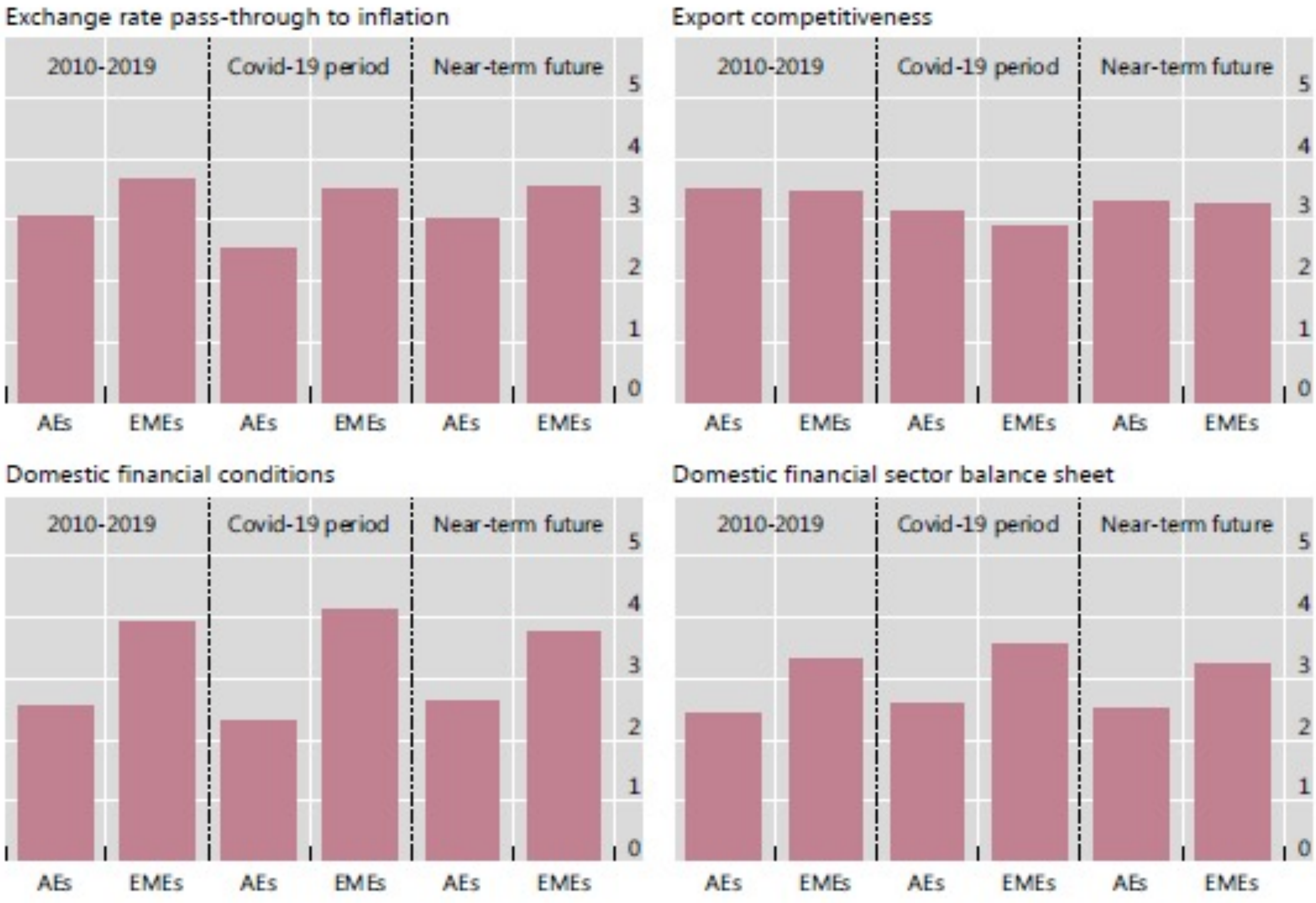
Sources: Survey of central banks; Federal Reserve Economic Data (FRED); Bloomberg; CGFS Working Group calculations.

Benefits and risks from capital flows

- 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.*

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

Average scale (1=not relevant, 5=very relevant) Graph B16



Source: CGFS Working Group, Survey on changing patterns of capital flows, August 2020, question 14.

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.

Policy issues and lessons

I. Policies that address short-term vulnerabilities are no substitutes for long-term reforms.

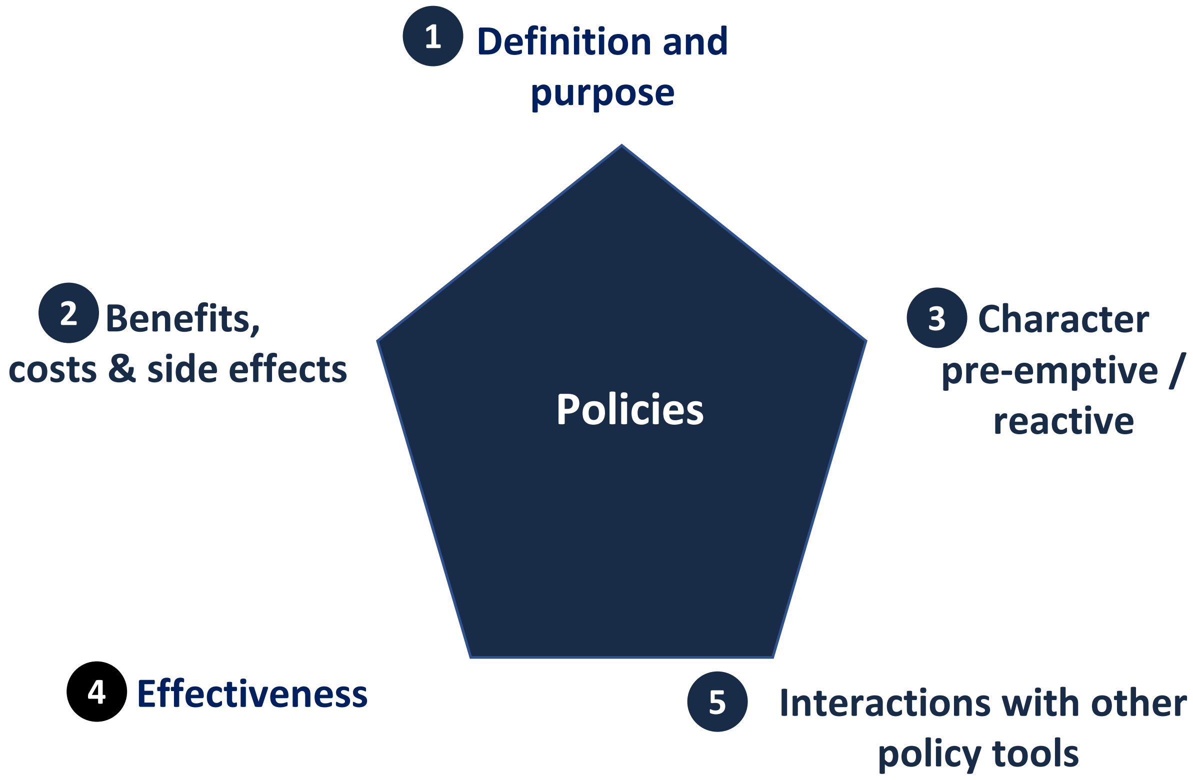
Structural

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

Policies to manage capital flow-related risks

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



Policy issues and lessons

II. There is no "one-size-fits-all" prescription

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

Capital Flow Management Tools

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.

Policy issues and lessons

II. There is no “one-size-fits-all” prescription

Policy interactions

- **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.

Challenges & Complexities

- **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?

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

Policy issues and lessons

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

Policy issues and lessons

The **Covid-19** crisis illustrates how **policy responded** to materializing risks

COVID-19 shock → **Policy tools** → **Capital flows rebound**

EMEs record outflows
AEs dash for cash

Aggressive countercyclical response

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.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Annex. Policy issues and lessons

Tool	Benefits & side effects	Character pre-emptive/reactive	Effectiveness	Interactions
Monetary Policy	+Primary tool to foster price stability, affect financial conditions and economic cycle -Applies at an aggregate level.	P: reduce inflationary pressures. R: support exchange rate	**Central Banks prefer not to use monetary policy to address capital flows.**	Interacts with FX policy (mainly in EM).
Micro-prudential	+Enhances resilience of individual institutions. - Incentivizes expansion abroad.	Pre-emptive		Strengthens other structural policies.
Macro prudential	+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.	Pre-emptive	**Effective for mitigating excessive volatility from credit growth. Most effective to complement other policies.**	Complements FX and CFMs.
FX Intervention	**+ Restore market functioning, prevent extreme movements feeding into inflation** **-Impairs FX market development, misalignment of exchange rate.**	P: Reserve accumulation R: restore market functioning.	**Depends on adequate execution and communication, consistency with other objectives.**	**Strengthens monetary policy autonomy.**
GFSN	+Financial support to prevent crisis or mitigate its effects. **- Debate on whether GFSN is strong enough.**	P: buildup of reserves, FCL, swap lines, RFAs. R: IMF programs		**Strengthens structural policies, facilitates economic adjustment.**