CAPITAL FLOWS TOWARDS EMERGING MARKET ECONOMIES

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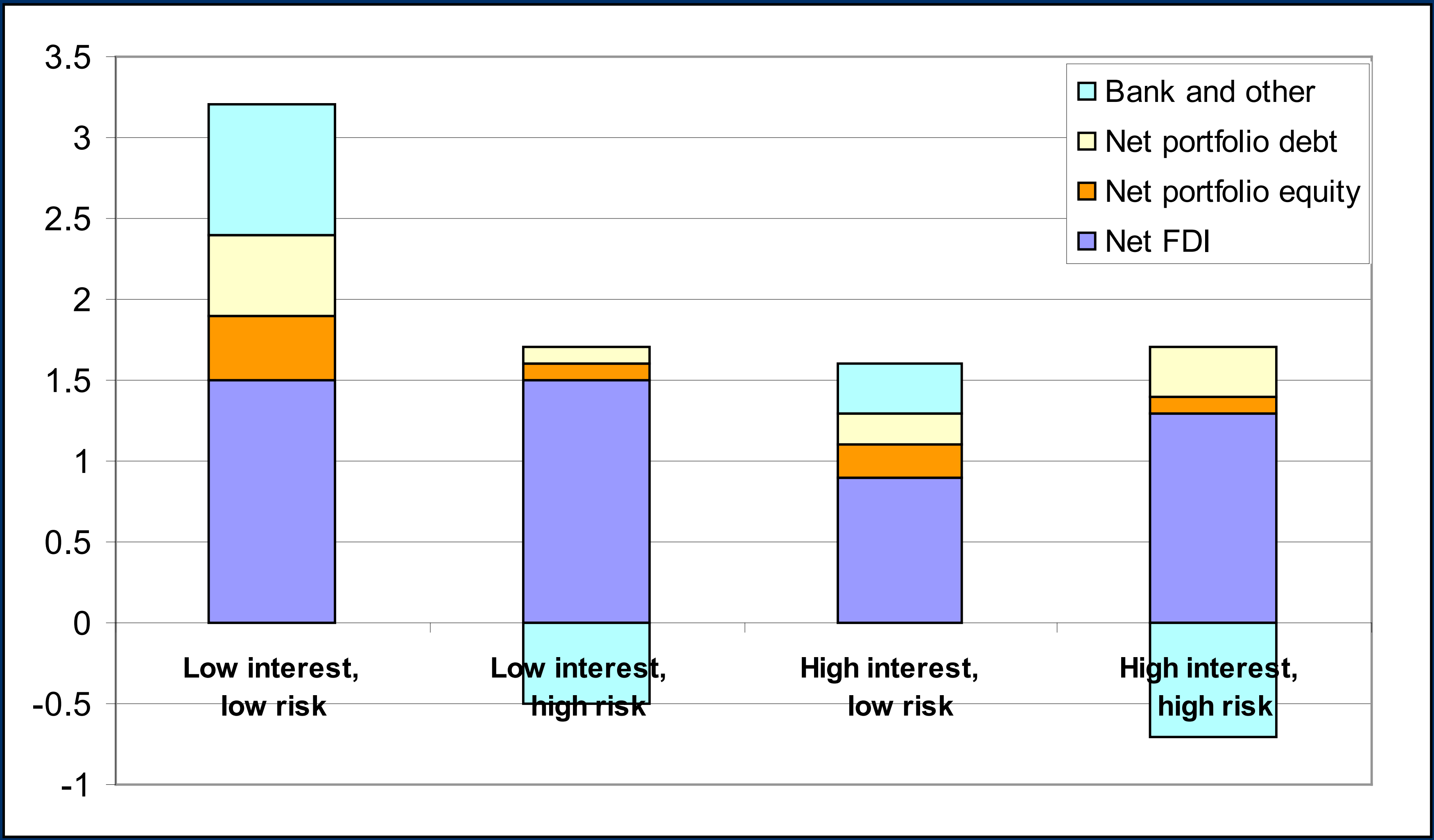
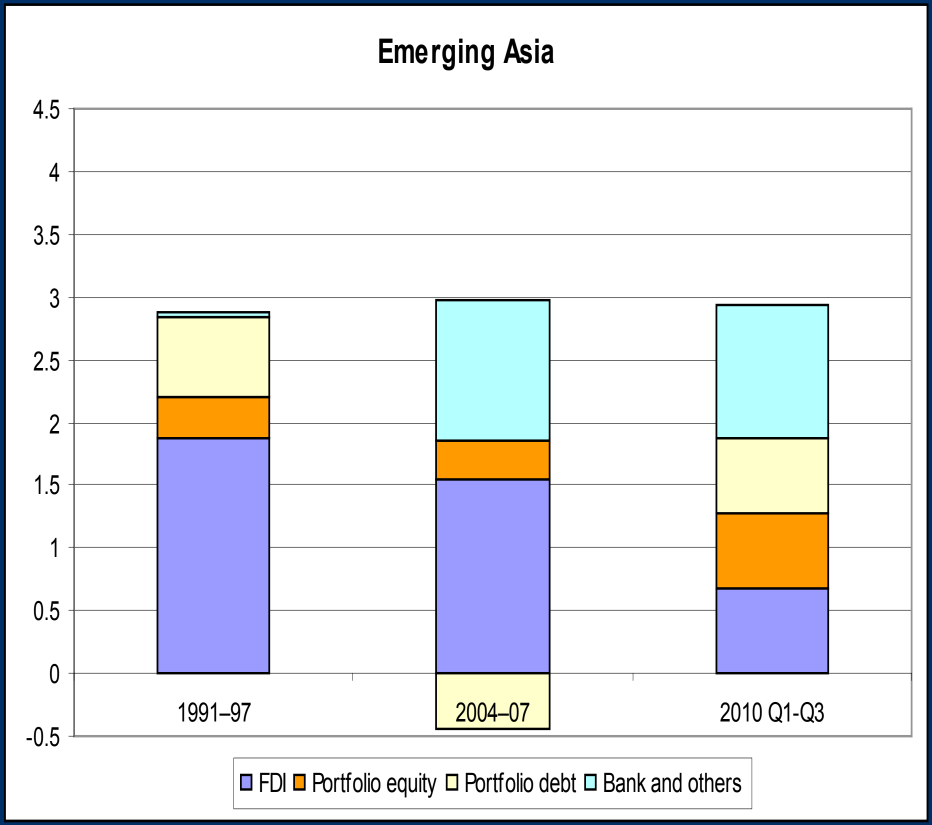
IMF *WEO*: Capital flows are erratic (fickle)

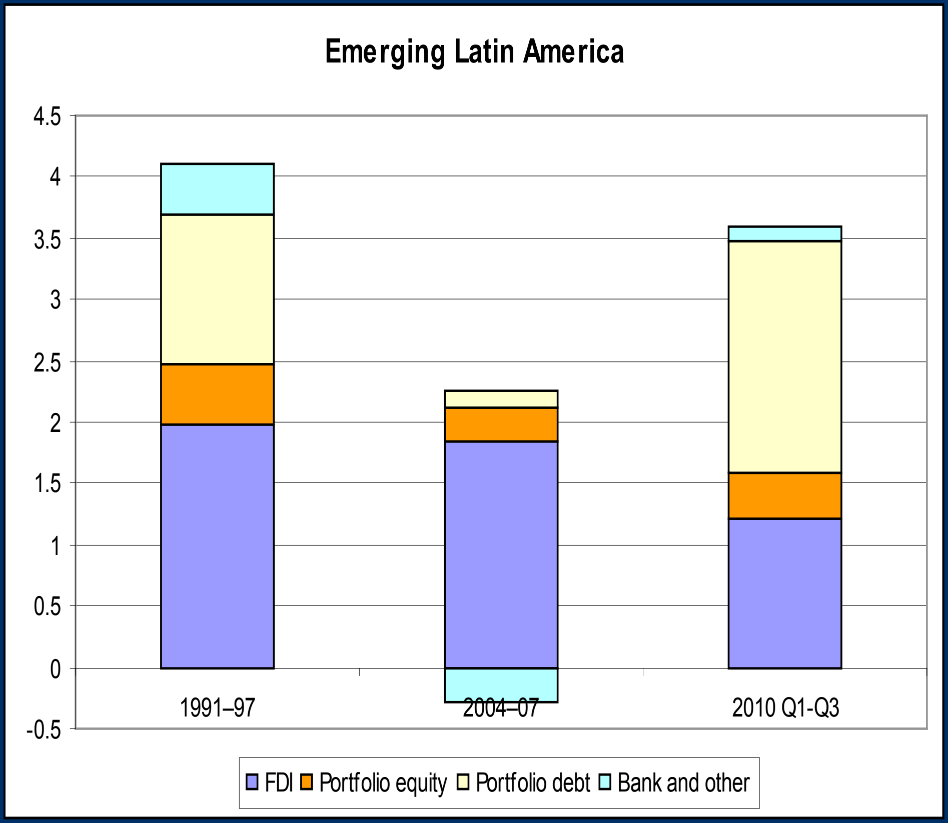
- ❖ Volatility has increased over time and is higher for EMEs than for AEs
- ❖ Flows towards EMEs are highly sensitive to monetary policy in AEs, and to risk perception
- ❖ Different types of flows differ in terms of volatility and persistence (though differences have narrowed down)
- ❖ Recent surge is peculiar because of pace rather than level
- ❖ Portfolio flows have been led the change in the supply of finance.

Bank and portfolio flows are highly sensitive to interest/risk mix

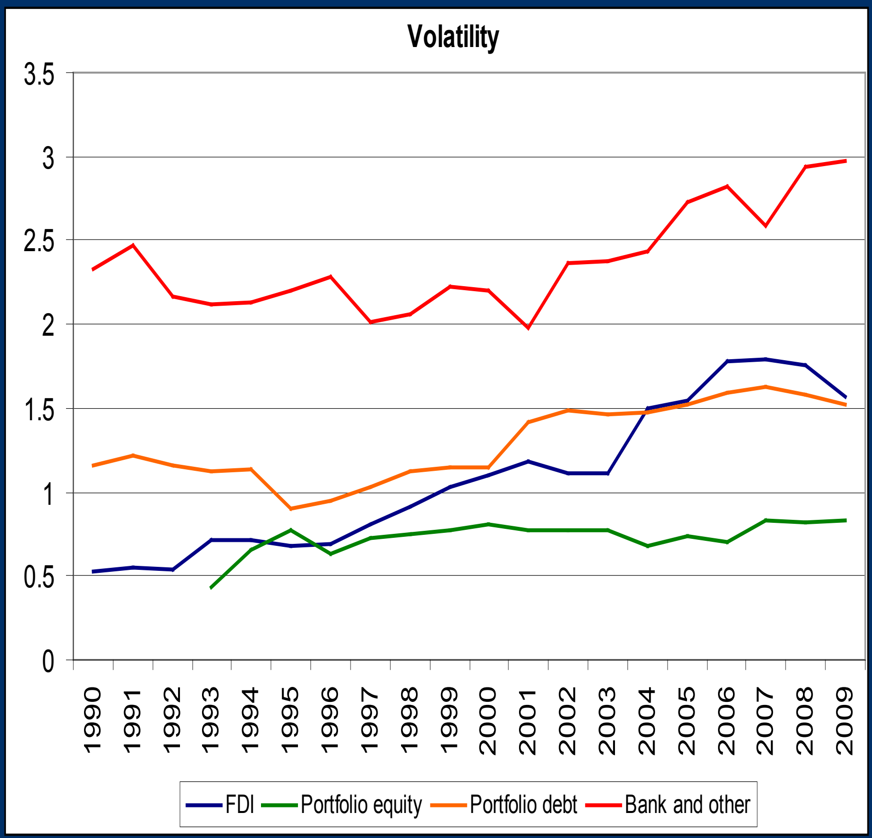


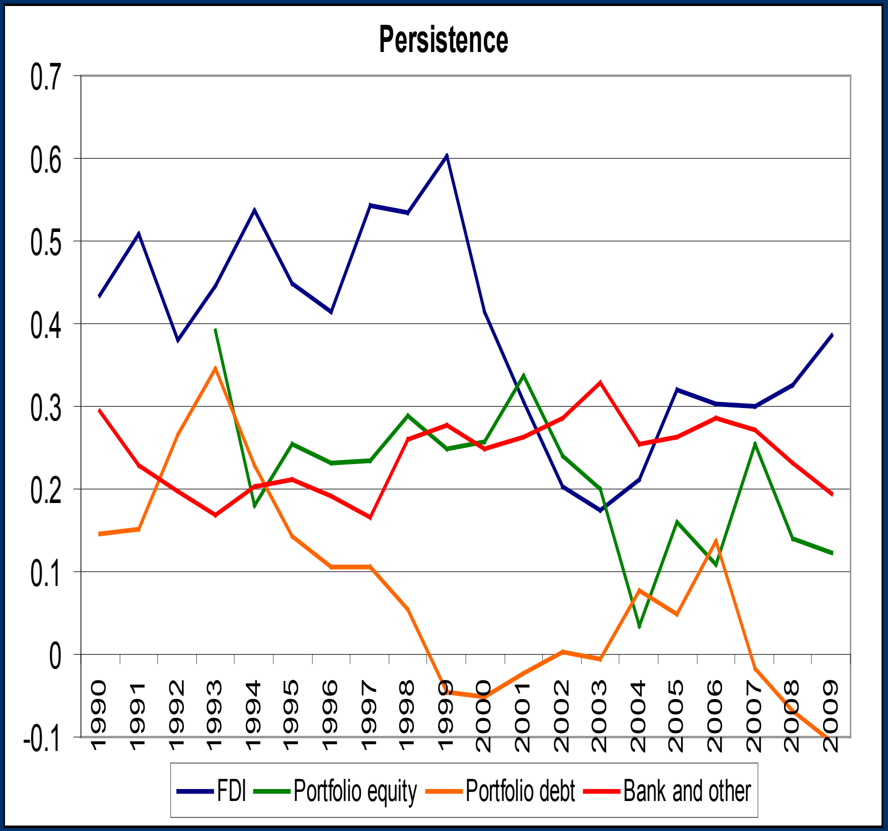
Debt portfolio flows are the distinctive feature of the recent surge





Volatility has increased, particularly for FDI. Persistence is low and has declined.

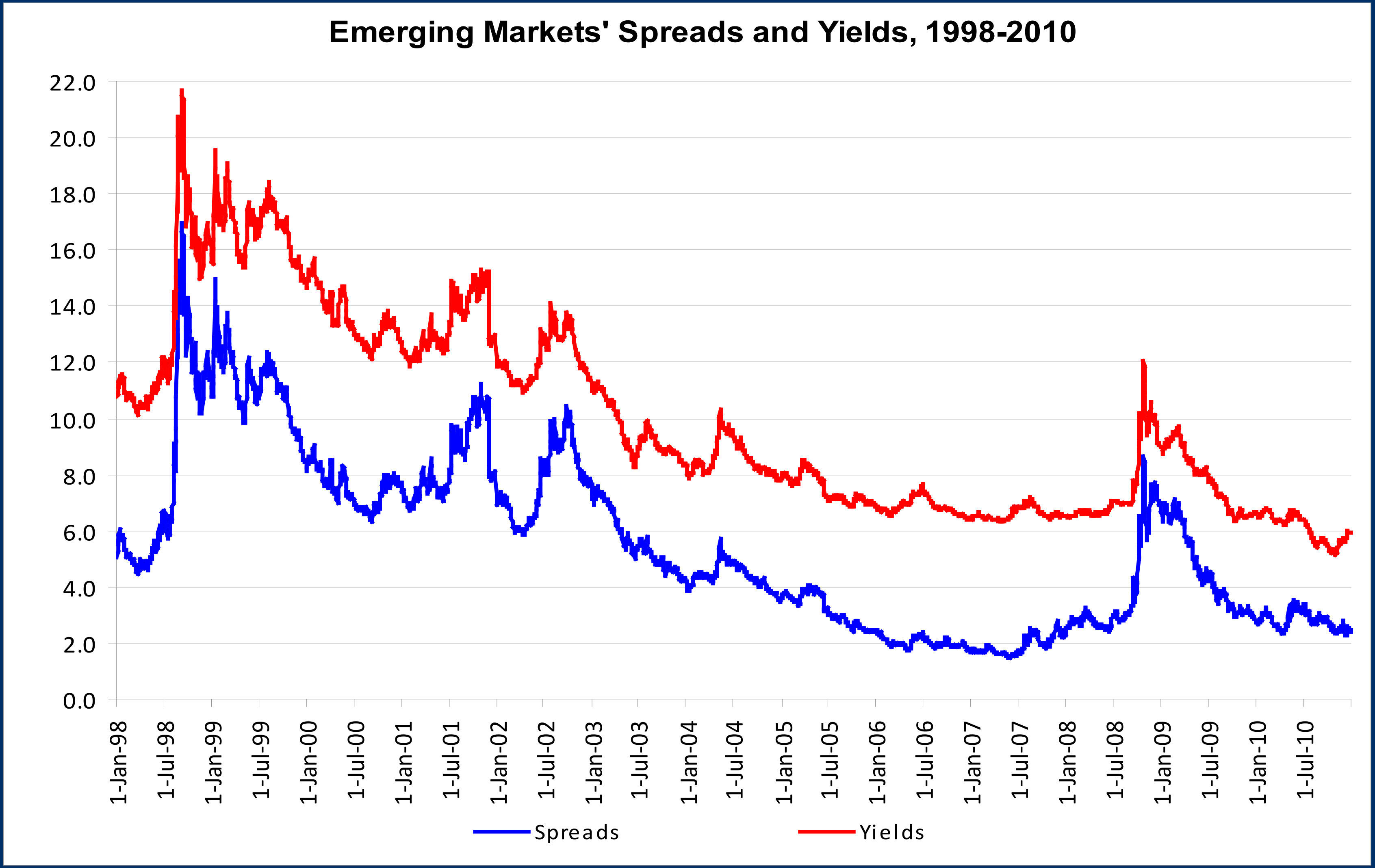




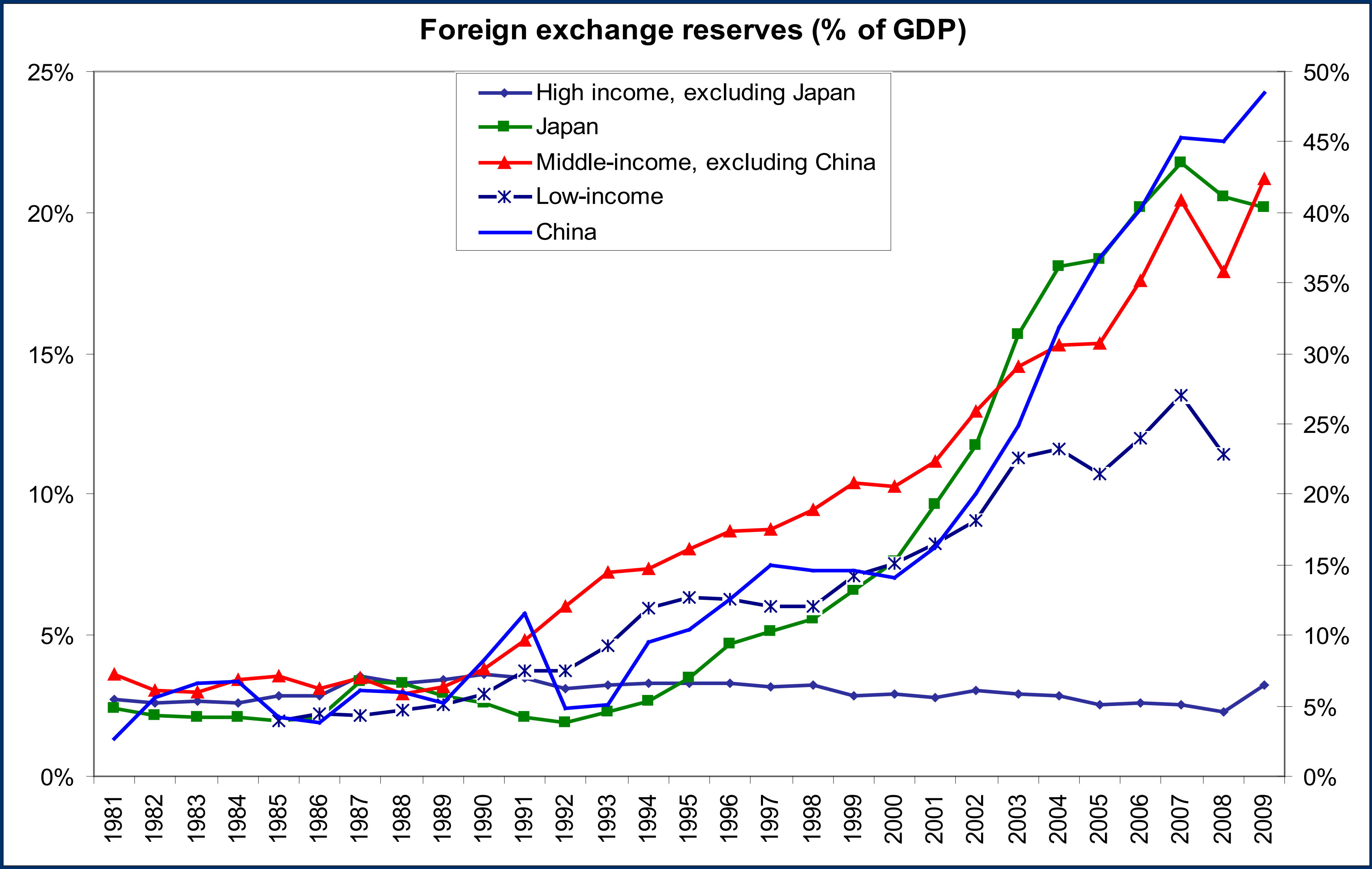
Some additional features

- ❖ Integration into global financial markets is a integration into a market that is segmented by risk categories.
- ❖ Segmentation has declined due to reserve accumulation and development of domestic bond markets…
- ❖ … but these achievements of EMEs have become a double-edge sword.
- ❖ EMEs markets are relatively small ➢ A small portfolio decision in AEs has major effects on EMEs
- ❖ Segmentation by currencies is still with us, and will continue

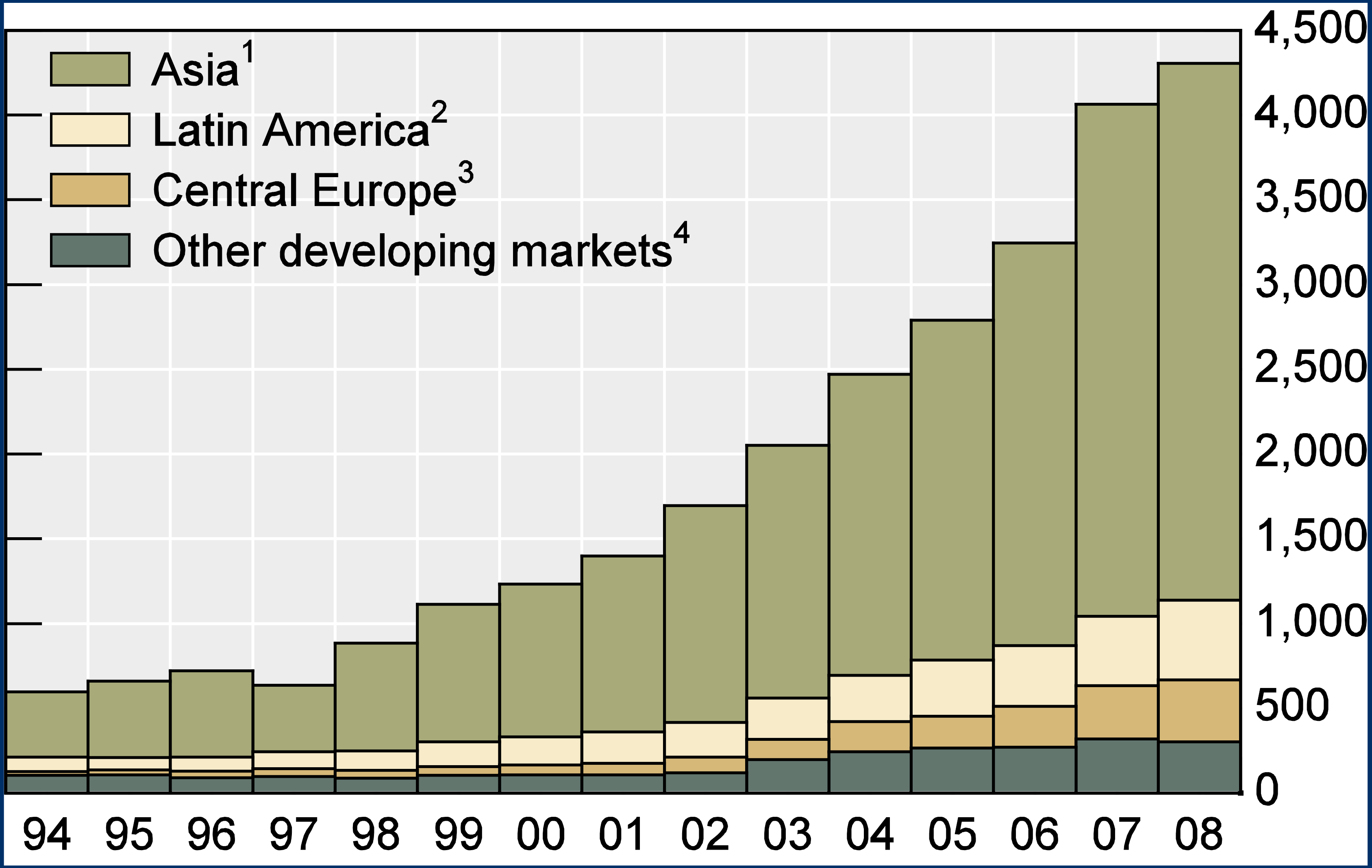
Segmentation has declined



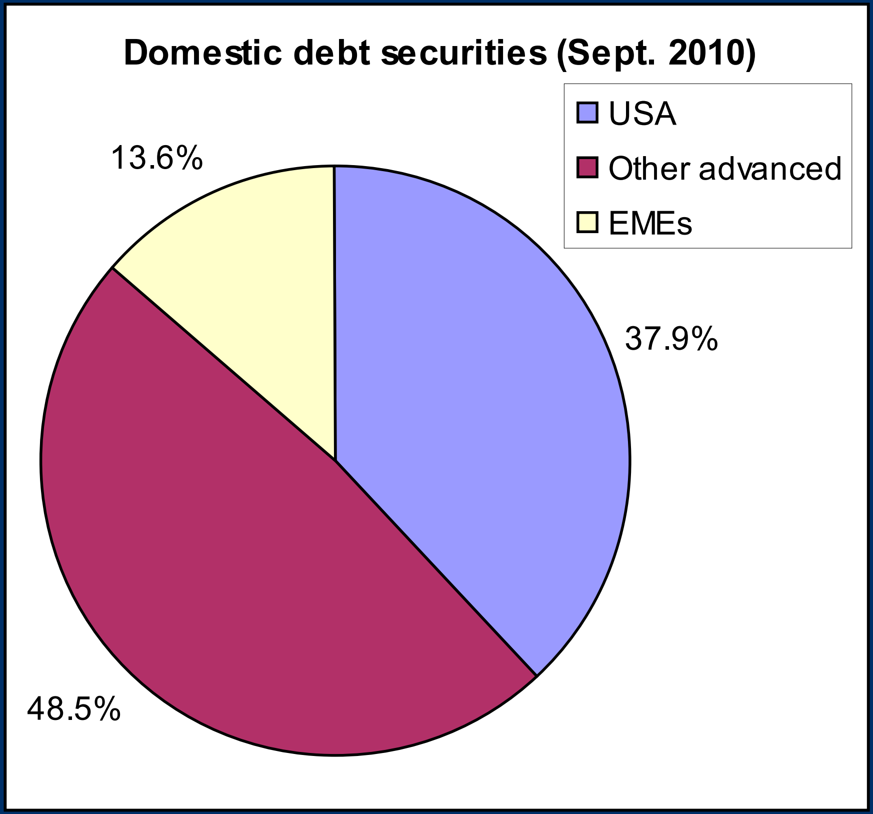
Due to massive reserve accumulation …

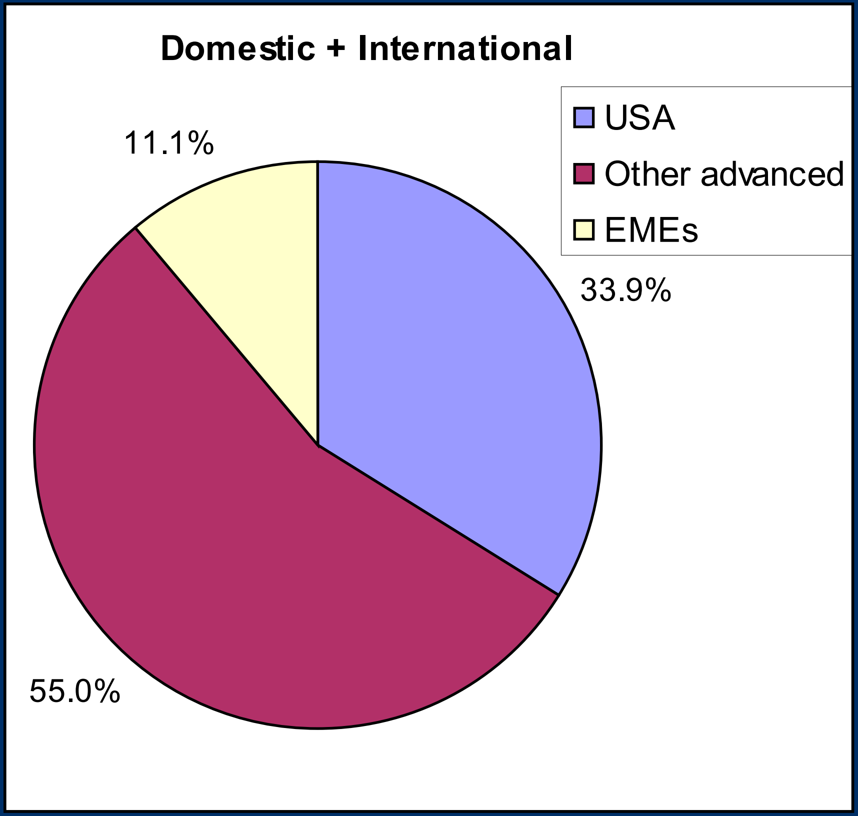


… and domestic market development in EMEs



Capital markets in EMEs are small compared to AEs





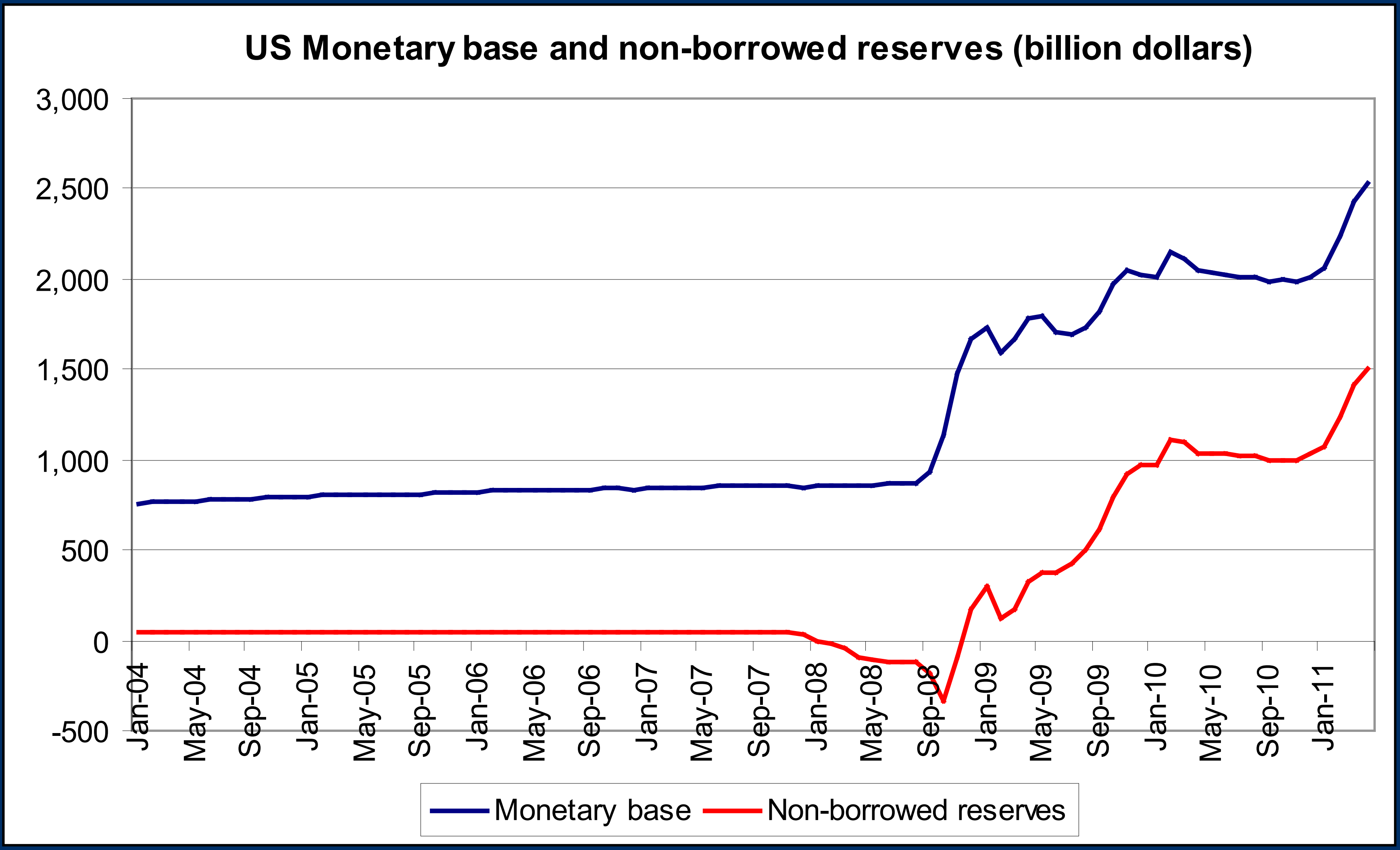
The current surge: explanations and paradoxes

- ❖ The problem is not QEs, which has been unable to increase the money supply in the US…
- ❖… but the interest rate differentials, which will continue to be with us due to:
  - ✓ Reduced risk perception
  - ✓ Two-speed world economy
- ❖ Two paradoxes:
  - ✓“Self-insurance” is good for financial stability but increases the flood
  - ✓Domestic financial market development has the same effect

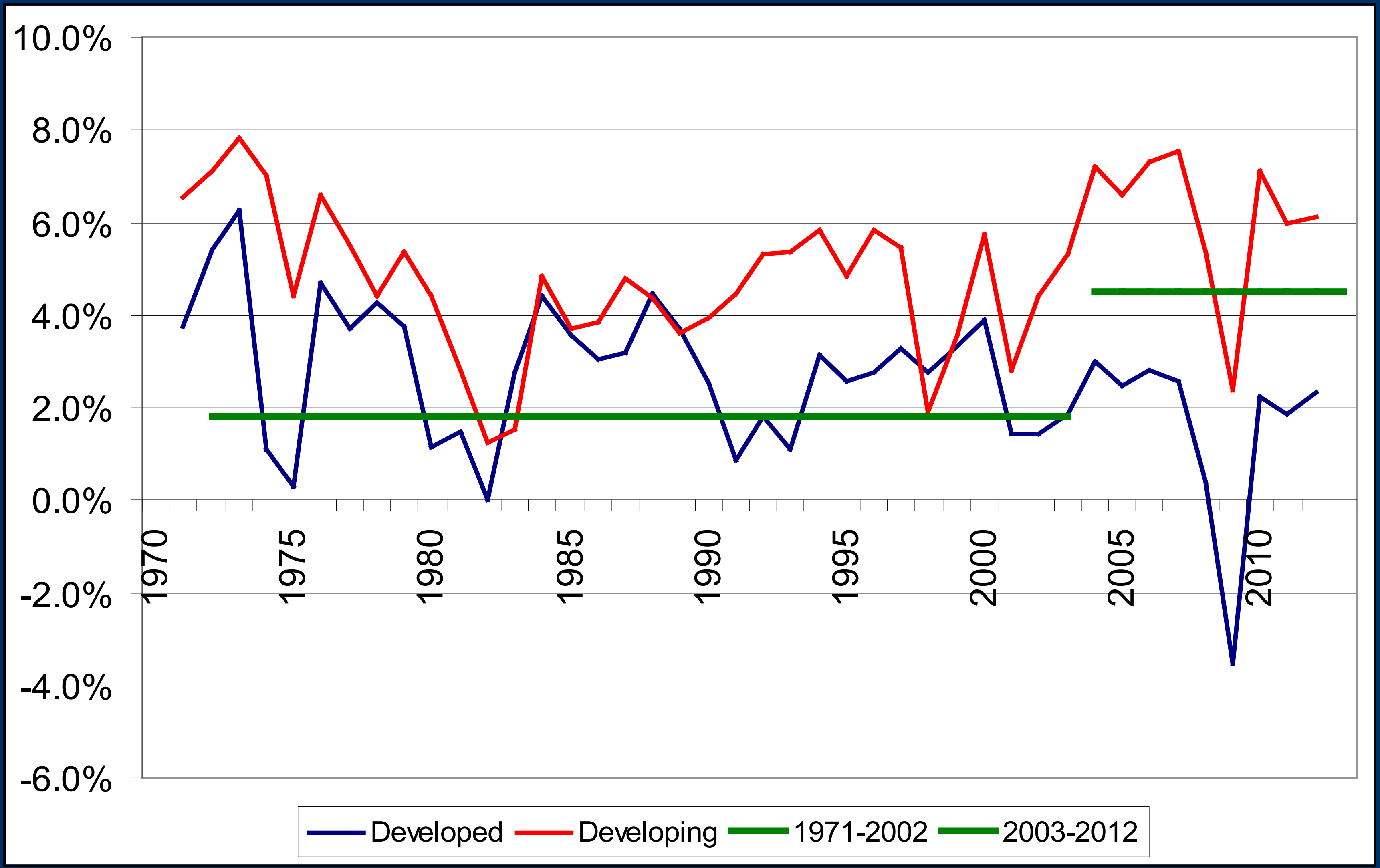
Major implications

- Stability of EMEs and free capital movements may just be inconsistent objectives.
- With structural imbalances in the world economy, interest rate arbitrage is a source of instability
- So, <u>global</u> (i.e., not only national) capital account regulations may be necessary to manage persistent incentives to interest-rate arbitrage.

Monetary base expansion in the US has led to increasing reserves deposited in the Fed



The two speed world economy, which has its mirror in monetary policies



What remains of the advantages of capital mobility / liberalization?

- ❖ Allow countries with limited savings to attract financing for productive investment

  … if countries can manage stable current account deficits; and, in any case, most financing does not lead to investment.

- ❖ Foster the diversification of investment risk

  Certainly for source countries; recipients, there are increased risks

- ❖ Contributes to the development of financial markets

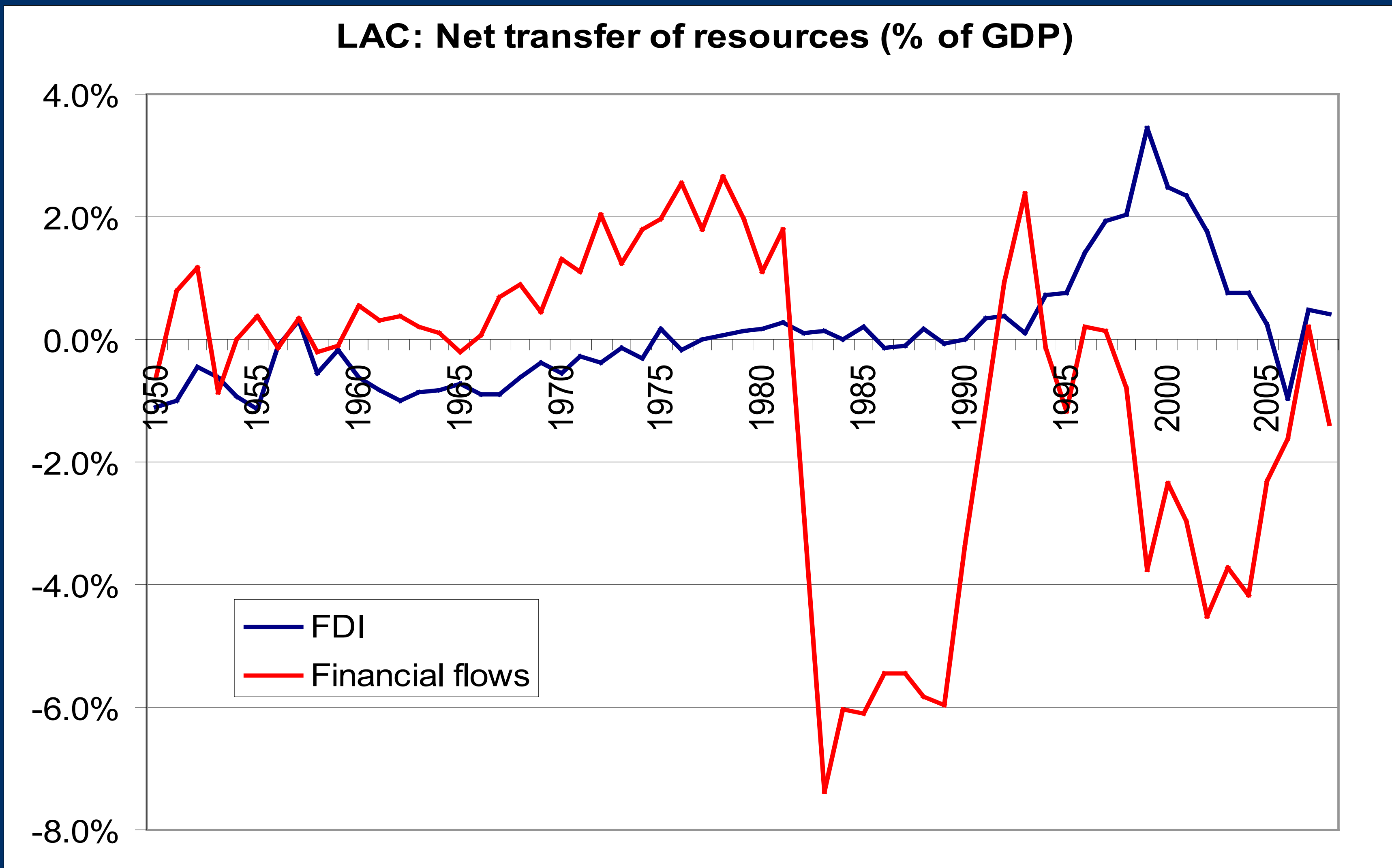
  Partly correct, so long as funds are stable

- ➢ Access to capital markets is obviously good, but capital account liberalization has no clear benefits.

A transition to the policy debate

- Medium-term cycles, not short-term volatility is what matters.
- Major issue: what determines policy autonomy?
- Exchange rate flexibility: countries are just choosing where they want the instability of capital flows to be reflected in the domestic macro-economy.
- Exchange rate flexibility has real costs.
- These two issues explains revealed preference for intermediate exchange rate regimes (heavy reserve accumulation cum capital flows)
- Major implication: capital account regulations may be an essential ingredient of counter-cyclical policies

Medium-term cycles is what matters



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