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Capital flows and GDP in emerging economies and the role of global spillovers☆

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ABSTRACT

This paper provides a global analysis of capital flow impacts on GDP for selected emerging economies. As additional control variables, we also include currency reserves and effective exchange rates in our analysis. We distinguish between gross and net capital flows and also assess the impact of both FDI and portfolio flows. Accounting for the fact that common factors have been the main drivers of capital flows while country-specific determinants ('pull' factors) drive the response to such shocks, we analyze shocks to country groups but consider country-specific responses based on a Bayesian time-varying panel VAR framework in the spirit of Canova and Ciccarelli (2009). Based on a sample of 24 economies, our results show a robust positive effect of capital flows on GDP. Except for Korea, both gross and net capital flows display a positive impact for around two quarters. The impact of effective exchange rates on GDP hardly offers an explanation for a possible transmission of capital flow effects with effective depreciations both positively and negatively linked to GDP. We also find that the effect of net portfolio flows is even more positive compared to net FDI flows for emerging economies. Finally, we provide evidence that the importance of global factors increases in times of crises.

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1. Introduction

The different facets of financial integration have been the subject of controversial discussions in recent years. In particular, the ambiguous effects of capital flows have led to different views and policy suggestions for emerging economies (Bertaut et al., 2012; Ostry et al., 2012; Forbes et al., 2015; Korinek and Sandri, 2016). Some economists argue that the recent financial downturn has had a large impact on capital flow patterns (Fratzscher, 2012). Forbes (2014) labels the recent development as

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financial deglobalization and finds that financial flows increase over time, fall sharply in times of crisis and do not rebound to anything close to the pre-crisis levels.[1] Concerns have been raised in particular for emerging markets as their capital flows will remain at low levels in 2016 (IIF, 2016). However, the structure of international capital flows has also changed in the sense that the degree of capital flows from and to advanced economies has decreased while the weight of emerging markets in global GDP has increased. Multinationals also increasingly affect capital flows by shifting their taxable profits to avoid taxes (Jones and Temouri, 2016).

Similar to the discussion about global current account imbalances, costs and benefits of financial integration in the form of capital flows are potentially different for surplus and deficit economies. They bear the potential to result in optimal allocation of production and improved economic performance. While financial markets per se have become more globalized, emerging economies have experienced the most drastic changes of their financial system over the last decades. Capital flows have played a key role in this context while inflows are responsible for fueling domestic financial markets and investments and unwinding outflows are potentially harming the domestic economy, for example during the Asian crisis. Rapidly increased foreign capital inflows are labeled as 'surges' and include several potential risks like contagion, suboptimal transmission of capital flows into the domestic economy and disruptive adjustments. Countries with underdeveloped financial systems are particularly vulnerable in case of 'sudden stops', which are reversals of capital flows (Forbes and Warnock, 2012).[2] International capital flows can create significant financial instability in emerging economies (Korinek and Sandri, 2016). Capital flow liberalization is more beneficial and less risky if countries have reached specific thresholds of financial and institutional development (IMF, 2012).

The macroeconomic implications of capital flows are closely related to exchange rates and currency reserves (Beckmann et al., 2017). If a country experiences large capital inflows, an accumulation of currency reserves is often considered to be aimed at improving competitiveness through preventing domestic appreciations although conclusive evidence of this view is hard to establish (Aizenman and Lee, 2008). From 1999 to the beginning of the subprime crisis in September 2008, foreign exchange reserves held by developing countries had more than quadrupled (Beck and Rahbari, 2011).[3]

This paper contributes to the literature by analyzing the macroeconomic linkages and effects of capital flows and reserve accumulation from a new global perspective. We focus on two main questions: (1) Is GDP in emerging markets affected by capital flows? (2) Are possible effects different for capital flows from emerging and industrial economies? Capital flows to emerging economies have historically mainly comprised foreign direct investments (FDIs) while recent capital flows mainly consisted of short-term inflows such as portfolio investments (IIF, 2015). We therefore examine effects stemming from capital flows both at an aggregated and a disaggregated level. Putting the effects on GDP over the last decades under closer scrutiny is well suited to analyze whether emerging markets have surpassed the (theoretically) required thresholds to experience a positive effect resulting from capital flows if both the overall size and the structure have increased over the sample period under investigation. In order to account for possible transmission channels, we also consider exchange rate effects stemming from capital flows. To tackle the questions mentioned above, we impose a factorization that allows for one common factor for industrialized economies and one for emerging markets besides country- and variable-specific factors which accounts for linkages between both groups. Relying on an extension of the data set of Forbes and Warnock (2012), we analyze effects of both net and gross capital flows and explicitly include the period of the recent financial crisis. Besides this aggregated perspective, we also assess the impact of both FDI and portfolio flows on GDP. Our quarterly data set compromises 24 economies and includes India, Korea, Mexico, the Philippines, South Africa, and Thailand as emerging economies. We are aware that some of these countries might be considered as industrial economies nowadays after experiencing economic and financial transformations over the sample period under investigation.

The need to consider a global perspective when analyzing effects of capital flows and financial integration is obvious. However, even if a panel of countries is analyzed, a caveat of previous studies is that they are not considering cross-country dynamics of capital flows and macroeconomic aggregates (Blanchard et al., 2015b). Such a setting does not account for common shocks which have turned out to be a key driver of capital flows and their volatility and the resulting dynamics during the recent crisis (Broto et al., 2011; Fratzscher, 2012).[4] The corresponding effects still have also been highly heterogeneous across countries so that a country aggregation when analyzing a response to shocks might result in biased conclusions. Altogether, common 'push' factors have been the main drivers of capital flows during the crisis, while country-specific determinants ('pull' factors) have been dominant in accounting for the resulting dynamics, in particular for emerging markets (Fratzscher, 2012). The consideration of cross-country dependencies is also crucial when emerging markets are analyzed based on historical evidence during the nineties. The Asian crisis is a textbook example of a situation where capital flow spillover effects resulted in contagion and significantly affected the real economy. Therefore, it is reasonable to consider the impact of a shock to all emerging economies rather than a country-specific shock while the response to those shocks should be examined based on country-specific responses. Moreover, time-varying coefficients are another essential modeling tool

[1] International capital inflows were only 1.6% of global GDP in 2013, ten times less than the peak of 16% in 2007 (Forbes, 2014).

[2] One view according to the first generation model of currency crisis is that unwinding capital flows result in speculative attacks on domestic currencies (Krugman, 2000).

[3] Fukuda and Kon (2010) analyze an unbalanced panel for the period between 1980 and 2004 and find a positive influence of foreign exchange reserves on economic growth which is not observed when controlling for an impact through investment.

[4] Portfolio flows by investors are for example not only driven by past returns but also positively correlated across countries and regions (Froot et al., 2001).

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