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Joining the club? Procyclicality of private capital inflows in lower income developing economies

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ABSTRACT

Using a newly developed dataset this paper examines the cyclicality of private capital inflows to low-income developing countries (LIDCs). The empirical analysis shows that capital inflows to LIDCs are procyclical, yet considerably less procyclical than flows to more advanced economies. The analysis also suggests that flows to LIDCs are more persistent than flows to emerging markets (EMs). There is also evidence that changes in risk aversion are a significant correlate of private capital inflows with the expected sign, but LIDCs seem to be less sensitive to changes in global risk aversion than EMs. A host of robustness checks to alternative estimation methods and control variables confirm the baseline results. In terms of policy implications, these findings suggest that private capital inflows are likely to become more procyclical as LIDCs move along the development path, which could render the conduct of countercyclical monetary and fiscal policies more challenging in these economies.

1. Introduction

Starting in the 1990s several low-income developing countries (LIDCs) have experienced a significant increase in private capital flows (i.e. capital flows excluding official development aid and loans).

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Initially, this increase was driven by foreign direct investment (FDI) flows but by the second half of the 2000s, several LIDCs were experiencing increased non-FDI private inflows (Araujo et al., 2015). Moreover, inflows to a number of these economies started to exhibit similar patterns and characteristics to inflows to emerging markets (EMs). In particular, numerous LIDCs experienced surges in non-FDI inflows in the period 2004–2008, i.e. LIDCs were "catching the wave" of the general increase in flows to developing countries in that period.

While greater access to international capital markets provides significant benefits to LIDCs (for example through investment and diversification opportunities, as well as an avenue for consumption smoothing in face of adverse shocks), it also brings new challenges for financial and macroeconomic stability. In fact, the empirical literature covering EMs and advanced economies has documented that international capital flows tend to amplify business cycle fluctuations and might reinforce the adverse consequences of procyclical policies that still tend to characterize a significant number of developing economies (Frankel et al., 2013; Kaminsky et al., 2005). Procyclical flows also exacerbate the procyclicality of the domestic banking sector with important implications for financial stability.[1] Hence, an assessment of the cyclical behavior of private capital flows to LIDCs is of crucial policy relevance.

In this context, it is useful to distinguish conceptually between three different cycles: the domestic business cycle (a staple of macroeconomic analysis); the domestic financial cycle (as captured for example by movements in domestic credit volumes, asset prices, interest rates, etc.); and the global financial cycle (movements in global liquidity, global risk aversion, etc.). The main focus of this paper is the association between capital inflows and the domestic business cycle, although we also discuss the role of global financial cycles. Nevertheless, one should bear in mind that there are important linkages between these three cycles that have been explored in a burgeoning literature (Obstfeld, 2014; Lane and McQuade, 2014, among others).

From the perspective of the capital receiving economy, if international capital inflows are countercyclical relative to the domestic business cycle, they could contribute to mitigate macroeconomic volatility and effectively provide insurance against adverse shocks.[2] Nonetheless, if capital inflows are procyclical, they would exacerbate macroeconomic fluctuations as well as amplify the domestic financial cycle, potentially contributing to fuel asset price bubbles and unsustainable credit booms.

In this paper, we investigate whether private non-FDI capital flows amplify or dampen economic cycles in LIDCs and whether the cyclicality of capital flows to these countries differs from the behavior observed for flows to EMs. For these purposes, we explore a new dataset constructed by Araujo et al. (2015) that overcomes some of the data limitations that tend to characterize capital flows in LIDCs.

Our main finding is that while gross private capital inflows are procyclical in general, they are less so in LIDCs relative to EMs. This conclusion is robust to alternative estimation methods and control variables. To our knowledge this is the first study to focus on the cyclical properties of gross non-FDI private capital flows to low-income developing countries using a variety of panel data estimation techniques and control variables. Previous efforts in the literature have documented unconditional correlations between broader measures of net (rather than gross) flows and the cyclical component of GDP, focusing on a comparison between OECD economies and emerging markets (Kaminsky et al., 2005) or have regressed a broad measure of gross capital flows, including FDI and international reserves, on real GDP growth as well as country dummies and a country specific trend, but do not include other control variables (Broner et al., 2013). Another recent strand of the literature has focused on the cross-sectional dimension of the data (Lane, 2015).

Moreover, our results suggest that flows to LIDCs are also more persistent than flows to EMs. Among the control variables, changes in risk aversion are a significant correlate of private capital flows in most specifications with the expected sign. In addition, the evidence also suggests that flows to LIDCs tend

[1] See Bruno and Shin (2014) for a practical discussion of the links between capital flows and the procyclicality of the banking sector. Lane and McQuade (2014) document the empirical links between domestic credit and international capital flows for a sample of advanced economies and emerging markets.

[2] For a theoretical and empirical discussion of the adverse effects of volatility on long-term growth emphasizing the role of procyclical long-term investment in face of credit constraints, see Aghion et al. (2010).