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Capital flows to emerging market economies: A brave new world?☆

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A B S T R A C T

We examine the determinants of net private capital inflows to emerging market economies (EMEs) since 2002. Our main findings are: First, growth and interest rate differentials between EMEs and advanced economies and global risk appetite are statistically and economically important determinants of net private capital inflows. Second, there have been significant changes in the behavior of net inflows from the period before the recent global financial crisis to the post-crisis period, especially for portfolio inflows, partly explained by the greater sensitivity of such flows to interest rate differentials since the crisis. Third, capital controls introduced in recent years do appear to have discouraged both total and portfolio net inflows. Finally, we find positive effects of unconventional U.S. monetary policy on EME inflows, especially portfolio inflows. Even so, U.S. unconventional policy is one among several important factors influencing flows.

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1. Introduction

According to economic theory, free movement of capital across national borders is beneficial to all countries, as it leads to an efficient allocation of resources that raises productivity and economic

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growth everywhere. In practice, however, as now appears to be well recognized, large and volatile capital flows can also create economic distortions and policy challenges.

In recent years, these challenges have come to the forefront again for emerging market economies (EMEs). After tanking during the global financial crisis of 2008–09 (GFC), net private capital flows to EMEs surged in the aftermath of the crisis and have been volatile since then, raising a number of concerns in recipient economies.[2] First, large capital inflows can overwhelm the intermediation capacity of the domestic financial systems, leading to excessive credit creation and asset price bubbles that create risks of financial instability. To the extent that the fickleness of international investors adds to flow volatility, it exacerbates these risks. Second, large capital inflows may cause currencies to appreciate, which in turn could hurt export and growth performance. Finally, large inflows can complicate the pursuit of appropriate macroeconomic policies to maintain solid economic growth without rising inflation. If, in response, authorities raise policy rates in an effort to prevent overheating, the move may encourage further capital inflows and boost currency appreciation pressures. But if they slow the pace of monetary tightening to deter inflows, or if they resist currency appreciation through intervention, the ability to follow appropriate monetary policies is compromised. And if they resort to capital controls, not only is it an open question how effective these may prove based on the past historical experience, but the use of such controls also risks creating economic distortions that could weigh on economic activity over the longer term.

EMEs appear to have employed a mix of policy responses to try and address these concerns that we will discuss in detail later. With advanced economies (AEs) providing powerful monetary stimulus to revive their sluggish economies and the EMEs facing a plethora of capital inflows amid strong recoveries, policy tensions arose between these two groups of economies. Several EMEs argued that the advanced-economy policies, including unconventional monetary expansion in the United States through large-scale asset purchases (LSAPs), were primarily responsible for the excessive flows of capital to their economies and created adverse spillover effects. More recently, with slowing capital inflows, EMEs have been concerned about the adverse effects of advanced-economy monetary policy normalization, which has already begun in the United States with the tapering of LSAPs.

In light of these developments, concerns, and policy tensions, our paper considers a number of important questions related to the behavior of private capital flows to EMEs in recent years and the policy responses they have triggered in the recipient economies: (1) What are the main drivers of private capital flows into EMEs? (2) Has there been a sea-change in their behavior from before the global financial crisis to after? (3) Did the capital control measures introduced in several EMEs after the GFC prove effective in slowing down these inflows? (4) How much did unconventional monetary policy easing in the United States spur capital flows into EMEs?[3]

We find that, first, growth and interest rate differentials between EMEs and AEs and global risk appetite are important determinants of net private capital inflows into EMEs. Second, there have been significant changes in the behavior of net inflows from before the GFC to the post-crisis period, especially for portfolio inflows, partly explained by the greater sensitivity of such flows to interest rate differentials. Third, cyclical capital controls introduced in recent years appear to have discouraged both total and portfolio net inflows. Finally, we find positive effects of unconventional U.S. monetary expansion on total and portfolio inflows, with the effect being larger for portfolio flows (compared with total) and gross inflows (compared with net).

The answers to the questions highlighted are not settled in the existing literature, and our results, summarized above, attempt to shed some further light. There are important policy implications that depend on these answers. For instance, the answer to the first question would seem to be crucial in

[2] This paper, and the related literature we discuss, deals with private capital flows to EMEs. Even with strong private net capital inflows into EMEs in the pre- and post-global financial crisis periods, it is worth noting that total capital has flown "uphill" from the EMEs to the advanced economies because outflows through official channels (reserves accumulation) have been larger.

[3] In an earlier version of this paper, we attempted to answer an additional question: To what extent are capital inflows into EMEs exacerbated by policies that allow only limited flexibility of the exchange rate? To do this, we used foreign exchange intervention data from Malloy (2013), whom we thank for generously sharing these data. The results are discussed in Section A. 9 of the appendix online.