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International reserves and gross capital flows dynamics [☆]

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ABSTRACT

This paper explores the role of international reserves as a stabilizer of international capital flows, in particular during periods of global financial stress. In contrast with previous contributions, aimed at explaining net capital flows, we focus on the behavior of gross capital flows. We analyze an extensive cross-country quarterly database – 63 countries, 1991–2010 – using standard panel regressions. We document significant heterogeneity in the response of resident investors to financial stress and relate it to a previously undocumented channel through which reserves act as a buffer during financial stress. A robust result of the analysis is that international reserves facilitate financial disinvestment overseas by residents – a fall in capital outflows. This partially offsets the drop in foreign capital inflows observed in such periods. For the whole sample, we also find that larger stocks of international reserves are linked to higher gross inflows and lower gross outflows. These results, which challenge current approaches to measuring reserve adequacy, call for refining such tools to better account for the role of resident investors.

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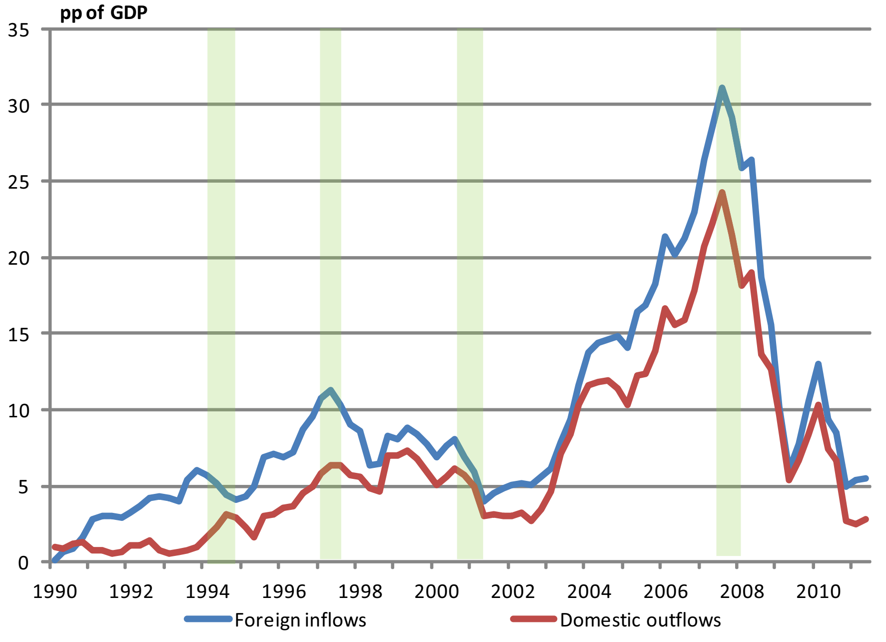

Graph 1. Gross capital flows in emerging economies.
Note: Average of gross capital flows, as % of GDP, for emerging economies – as classified in the Appendix. "Foreign inflows" are investments by foreigners, "Domestic outflows" are investments overseas by residents. Quarters of financial stress are dashed (1Q95, 3Q984Q01, 4Q08).

1. Introduction

In recent decades, the world economy has experienced a process of financial integration, with large increases in cross-border capital flows in both emerging and developed economies. The process has been far from smooth. As shown in Graph 1, where episodes of global financial stress (as defined in section 2) are depicted with a green shadowed area, cross-border capital flows have been increasing, grinding abruptly to a halt during the 1995–1996, 1998–1999 and 2001–2002 episodes of turmoil. Each time, they resumed soon afterward, reaching their peak at the onset of the 2008 global economic crisis. After their sharp collapse, financial flows are recovering again.[1] The picture is one of waves of increasing integration followed by episodes of sudden reductions in cross-border flows.[2]

While countries, in particular emerging economies, benefit from access to foreign savings, they can also be severely affected by episodes of disruption in cross-border capital flows. In fact, strong capital inflows can lead to exchange rate misalignments, foster credit booms and currency mismatches, and are subject to sudden stops. These can, in turn, trigger strong exchange rate depreciations, banking crises (Jeanne, 2010) and have long-lasting effects on GDP growth.[3]

Against this background, the challenge for policy makers lies in reaping the benefits of financial integration while managing these risks. Episodes of high capital flows to emerging economies have been managed with different tools. Macro-prudential policies and capital controls have sometimes been used during the upswing to prevent credit booms and financial instability. Even more often, in particular in the past decade, foreign reserve accumulation by Central Banks has been used to prevent

1 Bussiere et al. (2015) show that as reserve has reached the per-crisis level, the speed of accumulation has slowed down.
2 A similar picture emerges from Broner et al. (2013) and Forbes and Warnock (2012).
3 Bordo et al. (2010) use early 20th century data to show that sudden stops can have lasting effects on GDP growth.