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Large capital inflows, sectoral allocation, and economic performance☆

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ABSTRACT

This paper describes the stylized facts characterizing periods of exceptionally large capital inflows in a sample of 70 middle- and high-income countries over the last 35 years. We identify 155 episodes of large capital inflows and find that these events are typically accompanied by an economic boom and followed by a slump. Moreover during episodes of large capital inflows, capital and labor shift out of the manufacturing sector, especially if the inflows begin during a period of low international interest rates. However, accumulating reserves during the period in which capital inflows are unusually large appears to limit the extent of labor reallocation. Larger credit booms and capital inflows during the episodes we identify increase the probability of a sudden stop occurring during or immediately after the episode. In addition, the severity of the post-inflows recession is significantly related to the extent of labor reallocation during the boom, with a stronger shift of labor out of manufacturing during the inflows episode associated with a sharper contraction in the aftermath of the episode.

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1. Introduction

The last 30 years have seen a sustained process of financial globalization, with countries around the world opening their capital accounts and joining international financial markets. With the passing of time, both in academic and policy circles an initially benign view toward openness to international capital flows has given way to a more skeptical approach. The IMF's inclusion of capital controls in its recommended policy toolbox epitomizes the shift in thinking (Ostry et al., 2010; WEO, 2011). Not only are episodes of large capital inflows thought to set the stage for subsequent financial crises, but the impact of inflows on economic performance during tranquil times has also been called into question (Giavazzi and Spaventa, 2010; Powell and Tavella, 2012).

Fig. 1 summarizes the experience of Spain, which was in many ways typical of the countries in the Eurozone periphery. Following the launch of the Euro, Spain received large capital inflows resulting in sustained current account deficits (panel a) and coinciding with a consumption boom (panel b). Moreover, Spain experienced a shift of resources out of sectors producing tradable goods such as manufacturing and into the production of nontradable goods, such as construction (panel c). During the same period, Spain saw a slowdown in productivity growth (panel d). These developments have led some authors to draw a connection between episodes of large capital inflows and slowdowns in productivity growth, since capital inflows can trigger a movement of resources toward nontradable sectors characterized by slow productivity growth (Benigno and Fornaro, 2014; Reis, 2013).

While the narrative evidence from the Eurozone periphery appears compelling, it remains unclear to what extent these countries' experience is typical of recipients of large capital inflows. In the second half of the 1990s, Brazil received capital inflows and ran current account deficits that were unusually large by historical standards (Fig. 2, panel a). While Brazil did experience a consumption boom (panel b), the share of employment dedicated to manufacturing was steady or rising, reversing its earlier downward trend (panel c). Similarly, the inflows episode in Brazil saw a net improvement in TFP (panel d). Precisely how periods of large capital inflows affect recipient economies thus remains an open

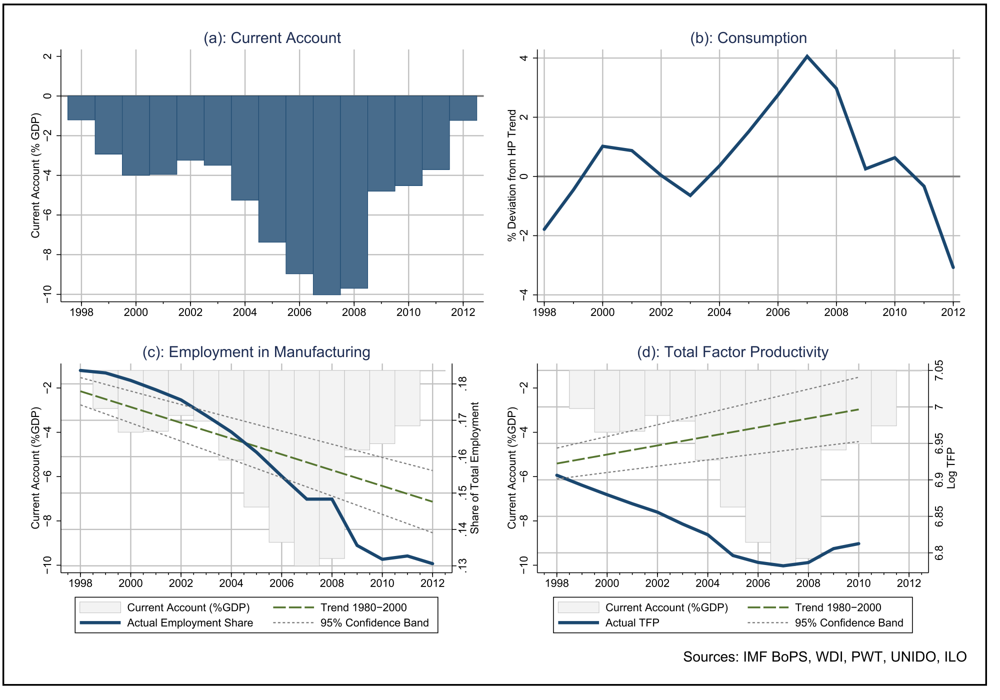

Fig. 1. Spain: Capital inflows and macroeconomic performance, 1998–2012.