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Capital Flows to Latin America: Prospects and Risks

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Starting in the early 2000s, Latin America experienced a boom in economic activity and increased financial integration with the rest of the world. This was accompanied by an increase in capital flows to the region, which provided ample funding and lowered borrowing costs for productive investment.

But over the past couple of years, as the region is facing a more challenging external environment, financial flows into Latin America have fallen by half—from more than 8 percent to 4 percent of GDP. With growth expected to be more subdued in Latin America over the next five years, are capital flows to the region expected to fall further?

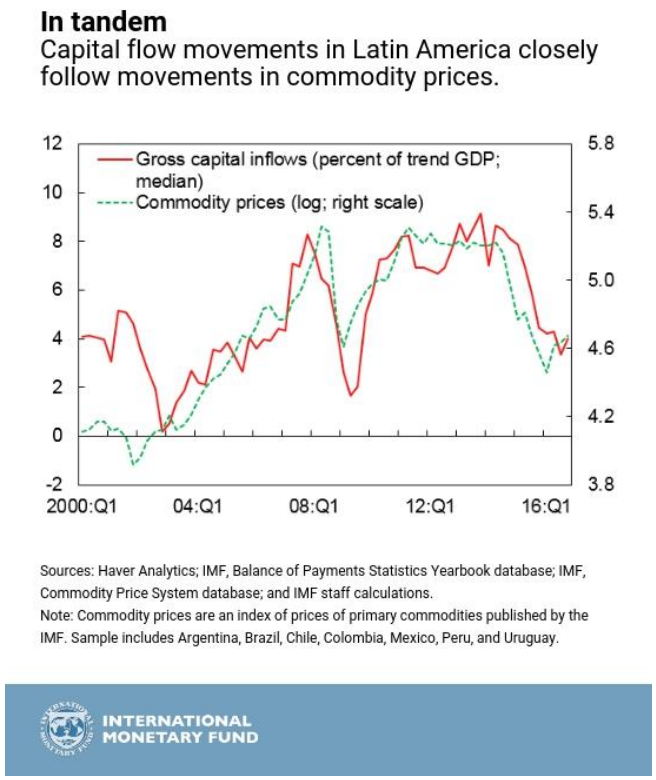
A better understanding of what drives capital flows over time and across countries is timely and important for policymakers as they consider policy options to manage the impact of capital flow swings and enhance their resilience.

In Chapter 4 of the latest *Regional Economic Outlook: Western Hemisphere*, we analyze the role of global and country-specific factors in driving capital flows. We find that short-term swings in capital flows to emerging market economies—and to Latin America in particular—are highly dependent on global factors, whereas country-specific factors play a key role in attracting capital flows over longer periods of time.

Capital flows over time

Capital flow swings to emerging markets behave similarly—suggesting a broader "global financial cycle." Latin America is certainly no exception, with 80 percent of the variation over time in capital flows being common to the region. In fact, over the short term, swings in capital flows to the region appear to be highly linked to external factors, including global growth and global market conditions. Moreover, one of our most striking findings is just how closely capital flows track movements in commodity prices. The two commodity price cycles between 2002 and 2008 and between 2009 and 2016 coincided with waves of capital flows into the region.

The importance of commodity prices does not simply reflect the fact that several Latin American economies are commodity exporters. Instead, commodity prices seem to reflect a combination of two underlying forces that together appear to be the real drivers of capital flows. First, commodity prices are fast-moving indicators of global aggregate demand, which expanded with the growth of large emerging markets like China and collapsed during the Great Recession. Second, commodity prices seem to be strong indicators of a "global financial cycle."



Capital flows across countries

Over longer time horizons—that is, beyond the usual business cycle—we observe wide differences between countries in the *average levels* of capital flows that they attract. For example, between 2000 and 2016, Chile attracted gross inflows of almost 8 percent of GDP, while Ecuador recorded inflows of just around 1 percent of GDP.

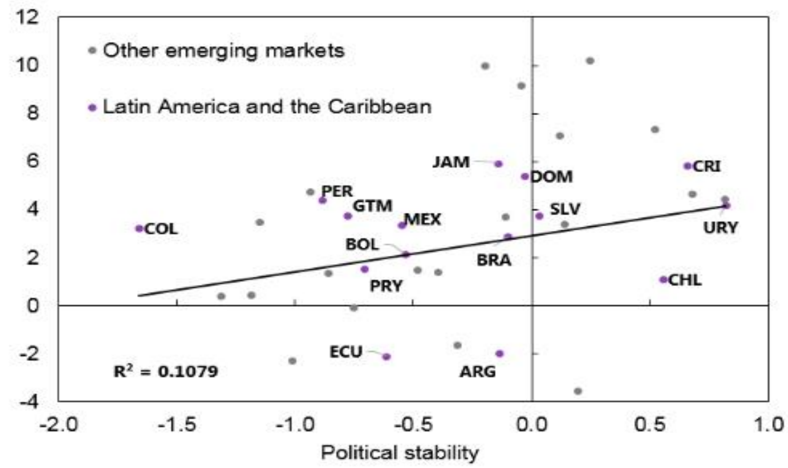
What could explain these wide differences between countries? We find that measures of institutional quality, political stability, good governance, and ease of doing business can explain most of these structural differences in capital flows.

In the chart below, the left panel shows that countries with more stable political environments tend to attract higher net capital inflows, on average. In the right panel, we see that countries with closer adherence to the rule of law tend to attract higher foreign direct investment—the largest subcomponent of capital inflows. Similarly, countries with more political accountability, better control of corruption, better regulatory quality, lower corporate tax rates, and higher credit ratings are all associated with higher capital inflows over the long term.

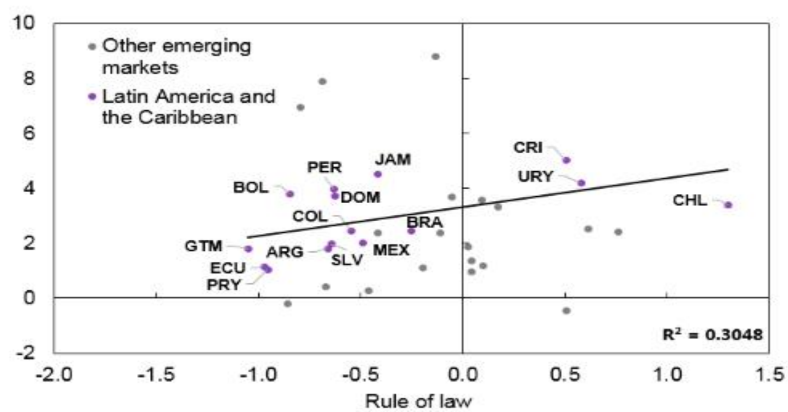
Institutions matter

Structural differences in capital flows between countries are closely associated with the quality of institutions.

(net inflows, percent of trend GDP)



(foreign direct investment, percent of trend GDP)



Sources: Haver Analytics; IMF, Balance of Payments Statistics Yearbook database; World Bank, Worldwide Governance Indicators database; and IMF staff calculations.
Note: Political stability and the rule of law are composite indicators from the World Bank's Worldwide Governance Indicators database. Data are averages for 2000-16.

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Policy implications

We have seen that capital flows can be quite volatile in the short term, depending on global conditions. This, in turn, can affect domestic economic conditions and complicate monetary and fiscal policy decisions. But the sensitivity of capital flows to global shocks is lower for countries with:

- Deeper and more liquid domestic capital markets.
- A greater share of their financial intermediation performed by domestic investors such as pension funds (as opposed to say, mutual funds or hedge funds). This could reflect the fact that pension funds invest for the long term, rather than frequently varying their exposures.
- More flexible exchange rates. By allowing flexibility, some adjustment appears to take place through prices (exchange rates), rather than through quantities (capital flows).

Although swings in capital flows often can be largely externally driven, domestic policies can soften the impact of global shocks on short-term capital flow volatility. To attract larger capital inflows over the long term, the role of institutions and tax systems is key.

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