PRESS POINTS FOR CHAPTER 4:
INTERNATIONAL CAPITAL FLOWS: RELIABLE OR FICKLE?
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Key Points
This chapter analyzes the nature of private cross-border capital flows and finds that:

- Net capital flows to emerging market economies recovered in a strikingly short span of time after the global crisis, but the rebound was more extraordinary in terms of its pace rather than the level capital flows reached.

- Net flows have become somewhat more volatile over time, and their persistence has generally been low.

- Net flows to emerging market economies tend to temporarily rise in periods of easy global financing conditions—i.e., when global interest rates are low and risk appetite high—and fall afterwards.

- Greater direct financial linkages with the United States entail a greater effect of U.S. interest rate changes on net capital flows. Economies with direct U.S. financial exposure experience a negative additional effect of U.S. monetary tightening on net flows, proportional to the size of their exposure. This additional effect is stronger when the U.S. rate hike is unanticipated and global financing conditions are easy.

Net capital flows to emerging market economies staged a strong comeback from mid-2009, although the rebound was more extraordinary in terms of its pace rather than the level net flows reached. Even in those regions where net flows were very strong (e.g., Latin America, emerging Asia), the levels were comparable to the averages experienced in previous surges, such as before the Asian crisis (1991-97) and global financial crisis (2004-07), and did not exceed historical peaks.

Net capital flows have become slightly more volatile over the last thirty years, and in general exhibit low persistence. Net flows to emerging market economies are slightly more volatile than those to advanced economies. Debt-creating flows—such as bank and other private and portfolio debt—are somewhat more volatile and less persistent than others.

Capital flows to emerging market economies appear to move in tandem with global financing conditions. In particular, net flows to emerging market economies rise sharply in
periods of easy global financing conditions—when global interest rates and risk aversion are both low—and fall afterward. Net flows are also temporarily higher in emerging market economies when their growth performance is stronger than that in advanced economies. The rise and fall in capital flows is most prominently driven by bank and other private flows.

**Economies with direct financial exposures to the United States experience a negative additional effect in net capital inflows in response to U.S. monetary policy tightening compared with those with no such exposure.** Direct U.S. financial exposure is measured by the share of an economy’s U.S. assets and liabilities in total external assets and liabilities. For an economy with average direct U.S. financial exposure (16 percent), an unanticipated rise in the U.S. real interest rate by about 5 basis point causes a within-quarter ½ percentage point of GDP fall in net flows over and above what is experienced in an economy with no such exposure. This negative additional effect becomes larger over time. The effect is much smaller with the realized (or actual) rate rise (which may be partly or wholly anticipated).

**A number of factors influence the sensitivity of net flows to U.S. monetary tightening for directly financially exposed economies.** It increases with the level of direct U.S. financial exposure, and is stronger when global financing conditions (interest rates, risk appetite) are easy. However, this negative additional effect is smaller for directly financially exposed emerging market economies with relatively deep domestic financial markets and strong growth performance.

**Capital flow variability is likely to remain a fact of life for both emerging market and advanced economies.** The key is to ensure that such variability does not compromise economic growth and financial stability. As further discussed in Chapter 1, policymakers need to adopt the right mix of macroeconomic policies, prudential financial supervision, and macro-prudential measures to maintain strong growth in the face of variable capital flows.