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GETTING THE MOST OUT OF INTERNATIONAL CAPITAL FLOWS

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Getting the most out of International Capital Flows

Supporting long-term growth with structural policy reforms could have additional favourable effects via their impact on international capital flows.

- Countries' net foreign capital positions are strongly influenced by their structural policy settings. A corollary of the empirical evidence is that growth-enhancing reforms in emerging surplus economies could contribute to reducing global imbalances.
- The effect of structural policy reforms on macroeconomic risks associated with large capital inflows is ambiguous; better structural policies are likely to increase the *scale* of capital flows together with the associated risks but also to change their *composition* away from debt towards FDI which should mitigate such risks.
- To ensure that macroeconomic risks associated with large capital flows are minimised, structural policy reforms need to be complemented by an appropriate macroeconomic policy stance, particularly in respect of fiscal policy and exchange rates, as well as financial reforms to strengthen the prudential and macro-prudential framework.
- There may also be a role for some form of capital controls if designed in a way that minimises distortions in long-term investments and ordinary business activities, but these should preferably be subject to multilateral surveillance as in the framework created by the OECD Code of Liberalisation of Capital Movements.

1. Introduction

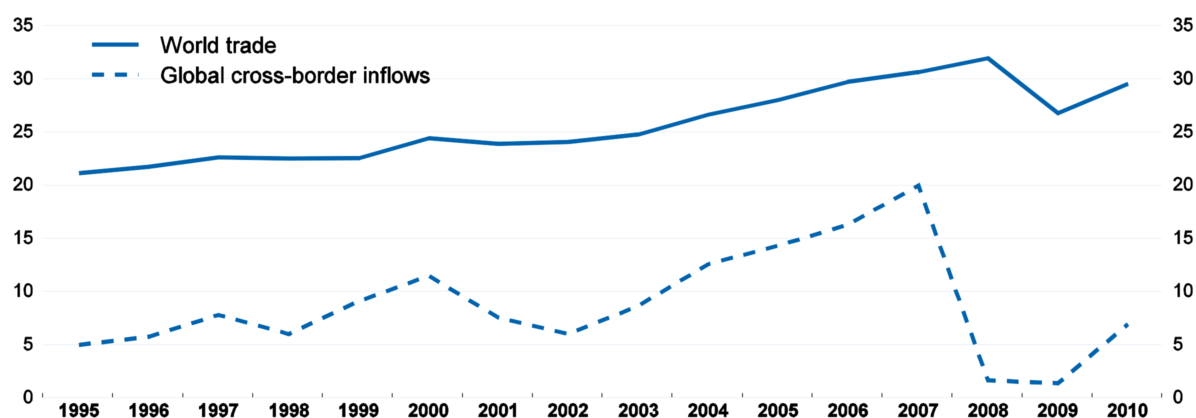
Increased international capital flows can support long-term income growth through a better international allocation of saving and investment. However, they can also make macroeconomic management more difficult because of the more rapid international transmission of shocks and the increased risks of overheating, credit and asset price boom-and-bust cycles and abrupt reversals in capital inflows. This note considers how policies can help to make the most of global financial integration in the context of the G20 goal to promote strong, sustainable, and balanced global growth. Particular attention is given to the role of structural policies -- broadly defined to include development of financial markets, general regulatory quality, as well as product market regulation that promotes competition and flexible labour markets. The conclusion is that better structural policies, as well boosting living standards and helping to reduce global current account imbalances, can increase financial integration while reducing financial vulnerabilities associated with it and thereby complement ongoing financial and prudential reforms.[1]

2. Structural policies contributed to increased global financial integration

Annual gross cross-border capital flows increased considerably from about 5% of world GDP in the mid-1990s to about 20% in 2007, a rate of increase about three times faster than that of world trade flows (Figure 1). In the years prior to the crisis, the dominant components were capital flows among advanced economies and notably cross-border banking flows, reflecting a strong increase in international banking activity. Financial development, capital account liberalisation, and increased trade openness seem to have been the main long-term forces driving increased global financial integration.

[1]. The empirical analysis underlying many of the results described in this note can be found in Furceri *et al.* 2011a, b and c.

Figure 1. Financial and trade globalisation
Per cent of world GDP



Note: 2010 global cross-border flows are estimated using available quarterly data.

Source: IMF Balance of Payments Statistics; OECD Economic Outlook 89 database; OECD calculations.

After reaching historical highs in mid-2007, international capital flows collapsed during the financial crisis. Initially, the contraction concerned mainly OECD countries' international banking flows, but the bankruptcy of Lehman Brothers in September 2008 precipitated a broader collapse. The financial crisis demonstrated the complexity and rapidity of the international transmission of financial shocks and the financial vulnerabilities associated with increased international capital flows. Capital flows have partially rebounded since spring 2009, driven by a bounce back in portfolio investment from advanced to emerging countries, which have proven quite resilient to the global crisis.

Going forward the same factors that drove increased global financial flows before the crisis are likely to increasingly reassert themselves. However, international capital flows, especially between advanced countries, may not reach pre-crisis levels as most countries undertake initiatives to reform financial regulation and tackle the failures that led to the financial crisis. In any case, increased international capital flows are likely to increasingly involve developing and emerging economies. For many countries this increase in international capital flows is likely to bring to the forefront of policy discussions, the issue of how to best manage capital inflows and minimise the associated macroeconomic risks, including those of credit bubbles, sudden stops or financial crises.

3. Growth enhancing reforms could reduce global imbalances

Structural policy settings appear to have a large impact on net foreign capital positions. Countries with more open financial markets, better institutional quality and more competitive product and labour markets seem to be more able to attract and absorb foreign and domestic capital flows and on balance these countries have lower net foreign assets. Structural policy reforms could therefore help to narrow global imbalances by reducing the large positive net foreign assets positions of some countries while also supporting their long-term growth.

Going forward, international capital is likely to flow more to emerging markets, given their expected progress in economic and financial development and institutional quality on the one hand, and the smaller scope for financial development and improvements in institutional quality in advanced economies on the other hand. Hence, better regulatory quality, greater financial development and capital account openness and more flexible labour and product markets would contribute to a reduction of net asset positions of emerging economies in the long term. Getting there would involve a reduction in current account balances over a long period of time during which net foreign asset positions adjust to their new levels. The

magnitude of these effects, while inevitably subject to wide uncertainty, is potentially large. Recent OECD empirical analysis suggests that if emerging market and transition economies improved their average level of regulatory quality to the level of high-income OECD countries, this could eventually be associated with a long-term reduction in net foreign assets by about 30 percentage points of GDP on average.

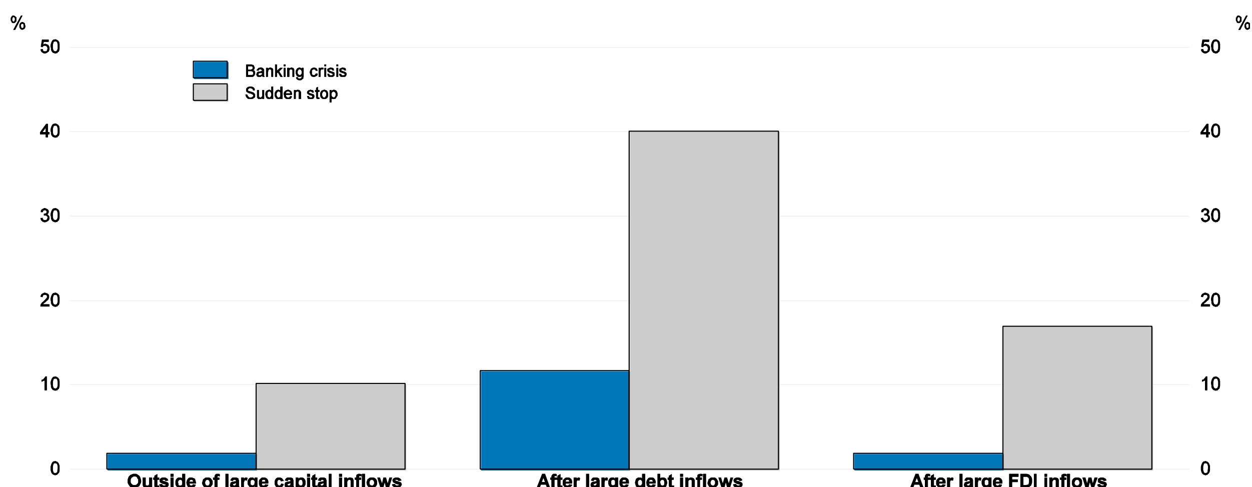
Still, countries differ. For example, in external deficit countries, notably emerging ones growth enhancing reforms may increase imbalances so that if wider deficits are deemed undesirable they might have to be complemented by other measures. In particular, reducing large fiscal deficits would have the double benefit of reducing risks associated with public debt sustainability and shrinking current account deficits.

4. Financial integration can entail risks

Global financial integration should have favourable effects on economic growth in many cases but it also implies increased risks. In 2010, although overall cross-border flows remained well below pre-crisis levels, several countries -- including Korea, Chile, Turkey and Mexico in the OECD as well as Brazil and some other large emerging market economies -- have faced large capital inflows and the associated challenges for macroeconomic management with prospective risks of credit booms, financial crises and sudden stops.

Overall about 60% of 268 episodes of large foreign capital inflows between 1970 and 2008 in both advanced and emerging countries (identified by large deviations of the net capital inflows-to-GDP ratio from its historical trend) ended in a “sudden stop”, and about one in ten episodes ended in either a banking crisis or a currency crisis. Considering only OECD countries, about 40% of the 75 large capital inflow episodes ended in a sudden stop and about one in ten episodes in either a banking crisis or a currency crisis. Empirical analysis shows that the probability of a banking crisis or sudden stop is multiplied by 4 after a large foreign capital inflows episode. The probability of facing a crisis or a sudden stop after large inflow episodes appears especially high when episodes are driven by debt inflows (Figure 2). Moreover, debt-driven episodes of large capital inflows tend to have a stronger impact on domestic credit than when inflows are driven primarily by FDI or equity portfolio investment.

Figure 2. Annual probability of banking crisis and sudden stops depending on the nature of the capital inflows



Note: Large capital inflow episodes are defined as large inflows (as share of GDP and given past volatility) relative to the trend experienced by each specific country. Banking crises are taken from Laeven and Valencia (2008) where the starting date is based on a combination of quantitative indicators measuring banking sector distress. Sudden stops are defined as a large fall in a country’s net capital inflows. For further details see Furceri et al. (2011c).

Source: OECD calculations.

5. Structural and macroeconomic policies can help mitigate risks

The overall effect of better structural policies on macroeconomic risks is, however, ambiguous. On the one hand, improved structural policy settings are likely to increase the overall scale of capital flows which will increase risk. On the other hand, better structural policies (more competition-friendly product market regulation, less stringent job protection, higher institutional quality and greater capital account openness) are associated with a composition of capital inflows -- principally more FDI and less debt -- which are more stable and less prone to risk. The overall net effect on macroeconomic risk will depend on the particular form of structural reforms enacted, but also on how they are buttressed by progress in financial reforms to strengthen the prudential and macro-prudential framework in both emerging and advanced economies. In this regard, macroeconomic policies, particularly exchange rate and fiscal policies, also have an important role to play in reducing vulnerabilities associated with capital inflows. Exchange rate flexibility appears to reduce some of the effect of large capital inflow episodes on domestic credit. In addition, countries that typically follow counter-cyclical fiscal restraint policy have -- on average -- experienced more moderate credit booms during large inflow episodes, and especially during debt inflows episodes. These are, however, general findings and related policy recommendations have to take into account countries' individual situations and constraints.

The role of capital controls is more complex. Capital controls are not always effective and create distortions if maintained indefinitely. This suggests that there is a strong need to review practices and develop commonly agreed principles on what could be appropriate in terms of capital controls. In this context, the OECD Code of Liberalisation of Capital Movements opens up the possibility of temporary capital controls as last-resort measures as long as such controls are designed and implemented in a way that minimises distortions on long-term investments and ordinary business activities and subject to multilateral surveillance.

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