Economic research on international capital flows: where do we stand 10 years after the Global Financial Crisis started?

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Financial globalisation has given international capital flows a central role in the functioning of the global economy, leading to considerable economic research over the past 30 years. Making the most of these capital flows has always been a challenge, as they can bring both good and bad. On the one hand, they can support long-term growth through a better international allocation of saving and investment, through technology and management improvements associated with FDI inflows or through enhanced transparency and corporate governance due to the exposure of flow recipients to international investors. On the other hand, they complicate macroeconomic management of recipient countries, increase financial vulnerabilities and amplify domestic distortions, and can lead to financial crises and sudden stops with negative implications for economic growth.

This challenge has become even more acute after the Global Financial Crisis financial revealed the complexity of global financial relations and their role in shock transmission. The crisis also questioned the ability of fundamentals to protect countries from financial instability and the global financial cycle. Overall it showed that global financial integration has not only led to an increase in the size of capital flows (annual gross cross-border capital flows increased from about

5% of world GDP in the mid-1990s to around 20% in 2007) but has also affected the drivers of these flows as well as the transmission and contagion mechanisms. For instance, there has been a growing decoupling between gross and net flows since the late 90s which means that surplus countries do not necessarily "finance" deficit countries, and economies with a balanced current account may still get important financing from abroad and be vulnerable to sudden stops. These changes have implications for a wide range of policies from surveillance, to how to best deal with inflows and outflows in order to reap their benefits while reducing associated risks. Moreover, over the past few years, while financial globalisation has marked a pause, the nature of capital flows has continued to evolve and new concerns have emerged.

The new OECD working paper *Findings of the Recent Literature on International Capital Flows: Implications and Suggestions for Further Research* takes stock of recent empirical and theoretical research. It assesses how this literature helps assess the current situation, associated risks and policy needs. The main findings are as follows.

- **Foreign debt accumulation by EMEs non-financial corporation has become a potential source of instability.** Foreign debt accumulated by EMEs non-financial corporation (NFC) has increased substantially since 2010. There is also evidence suggesting a significant part of this debt has been financing financial assets acquisitions or deposited in local banks rather than investment in fixed assets, supported by the favourable carry trade opportunities resulting from the low dollar interest rates. A USD appreciation and an increase in dollar interest rates could hence lead to a fast unwinding on some of these positions.
- **The protecting role of good fundamentals is being questioned.** The capital inflow surge to EMEs that followed the implementation of QE in advanced economies,

the “taper tantrum” episode, the vulnerabilities associated with EME corporate borrowing have all revived the debate on EMEs vulnerabilities to global financial shocks, especially the monetary policy stance in advanced economies. The analysis of push (global) and pull (local) factors has focused on the mechanisms by which push factors affect EMEs and whether some fundamentals affect the sensitivity of countries to these factors. and mitigate the impact of the global financial cycle. However, findings have been mixed, potentially questioning the traditional view that good fundamentals necessarily protect countries from financial turbulences.

- **The ability of exchange flexibility in mitigating the risks associated with capital inflows is also questioned.** The existence of a global financial cycle that affects countries independently of their exchange rate regime has questioned the ability of the move towards more exchange rate flexibility by many EMEs over the past two decades to shield them better from financial turbulences than the less flexible regimes of the 90s. This is especially the case as exchange rate fluctuations may amplify the impact of financial shocks via balance sheets effects. While this point is largely shared by recent analyses, the further implications for policy making including monetary policy and capital controls is under debate. While some argue that under full capital mobility, countries outside the US lose monetary autonomy, even with flexible exchange rate, and call for a greater use of prudential and capital flow management tools, (e.g. Rey 2016), others reject this view and rather stress that central bankers have to deal with worse trade-offs related to financial stability issues (e.g. Banerjee et al. (2015) and Obstfeld (2015)).
- **While capital controls have been increasingly considered as a complementary policy tool to deal with**

international capital flows, evidence on their impact remains inconclusive. The reliance on capital controls or more generally capital flow management measures remains an important, and yet unsettled, policy debate regarding international capital flows. As the risks associated with international capital flows have become more obvious, there has been a slow shift in the post-Bretton woods consensus view that capital should be allowed to move freely across countries and that the use of capital control, even in face of large inflows or sudden stops, was unwarranted. However, most of the issues regarding the use, effectiveness and spillover effects of capital control remain largely open, as empirical results point to different directions, partly because of the diversity of the measures of capital controls that have been used, the different time horizon and countries under review.

- **International policy coordination is essential**. Deeper global financial integration means that monetary and financial shocks are transmitted through the financial system across countries and that imbalances or credit booms abroad can affect the domestic economy and its stability, as seen during the financial crisis. Domestic policies, especially monetary and financial policies, may spill over to other countries and even have spillback effects on the domestic economy. Hence international cooperation and coordination of policies have been put forward to deal with international capital flows in three main areas: monetary policy; capital control management and more broadly financial policies; the global safety nets.

The paper points to many areas where further investigation is needed to guide policy making. They include the role of fundamentals in protecting countries against the risks associated with capital account openness, the impact of exchange rate fluctuations taking into account the balance

sheet transmissions channels, the costs and benefits of capital controls, financial policy spillovers, the costs and benefits of the global financial safety net, the drivers of capital outflows – especially as China is further liberalising its capital account–, how the characteristics of the sectors receiving/exporting inflows affect the drivers of the flows and their impact on the economy.

References:

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