# INTERNATIONAL CAPITAL FLOWS AND STRUCTURAL POLICIES

Seminar on **Investment and investment finance**
**The supply and demand of long term finance**

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BETTER POLICIES FOR BETTER LIVES

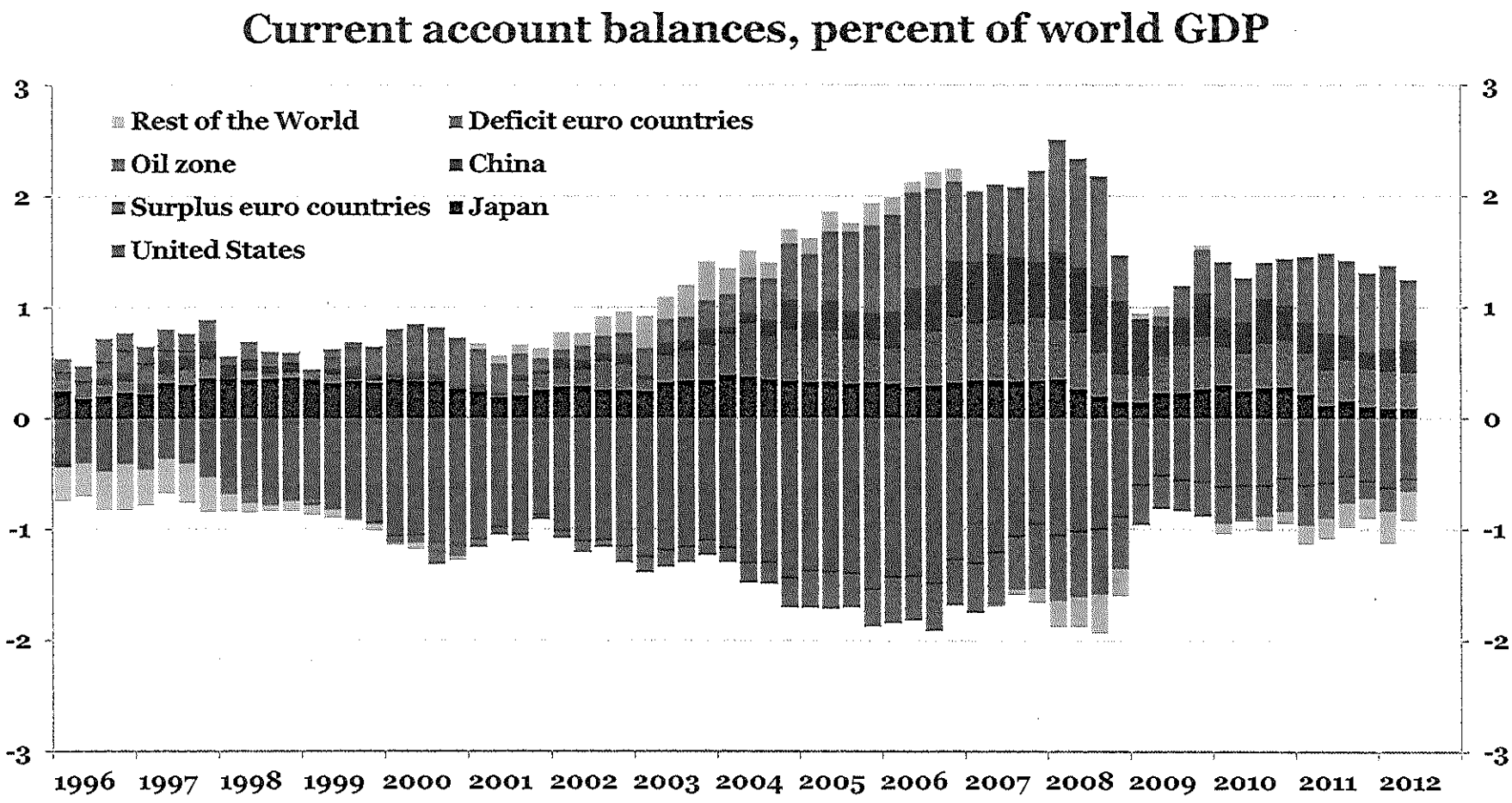
# Outlook

- Saving investment gaps will remain and widen generating capital flows
- Capital flows will determine the sustainability of imbalances
- Uphill capital flows reflect the need for better policies
- Structural policies can narrow SI gaps
- And make capital flows more sustainable

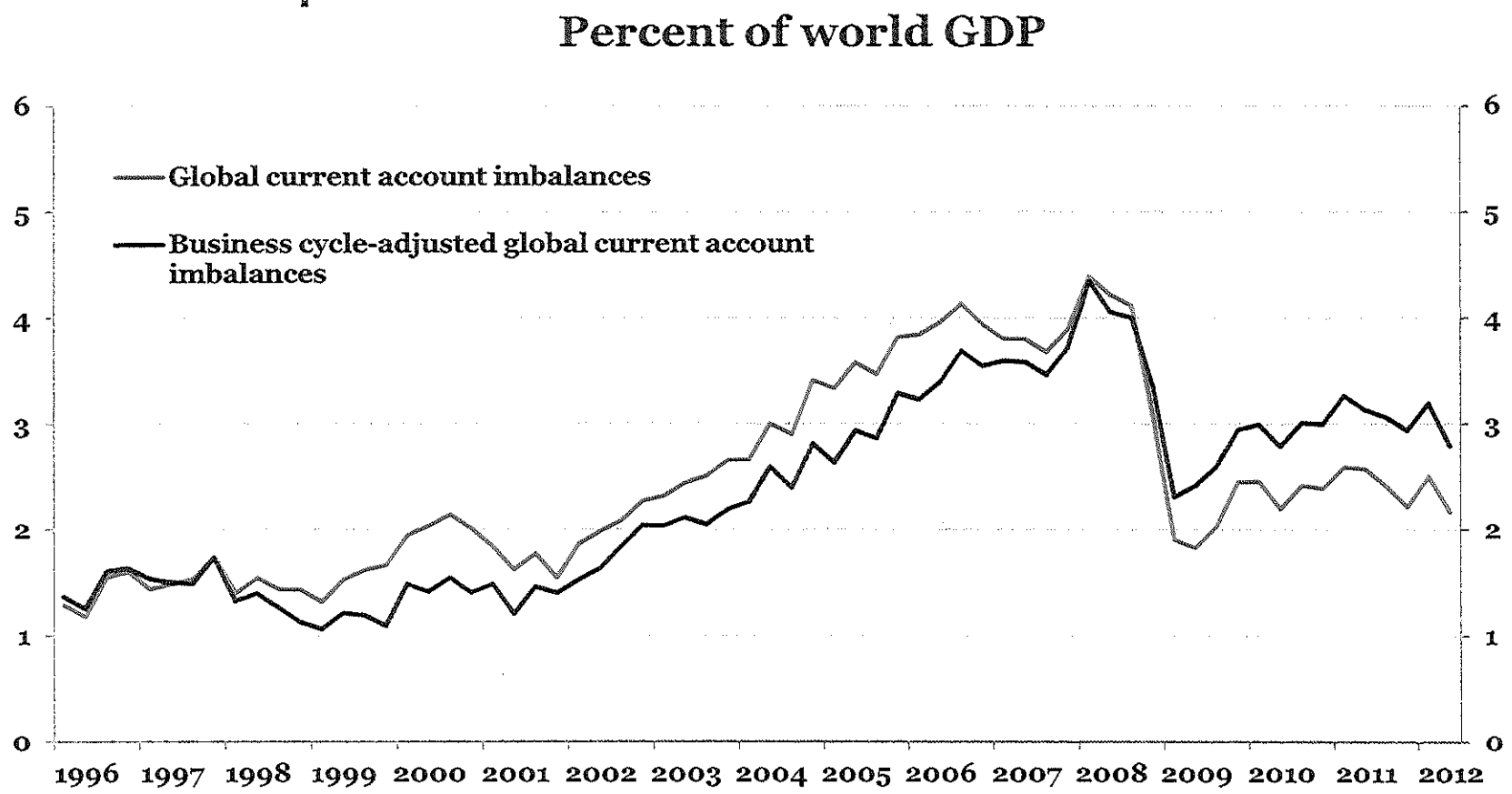
# Perspectives for capital flows. Lessons from the crisis

- SI gaps will remain and widen. Will generate capital flows
- Capital flows are a positive factor for the global economy as they reallocate savings
- But they may be source of instability depending on composition
- Capital flows have been moving uphill (from South to North) but reasons not fully clear

# Imbalances will remain and generate capital flows



# Underlying imbalances have fallen less than headline, reflecting structural components

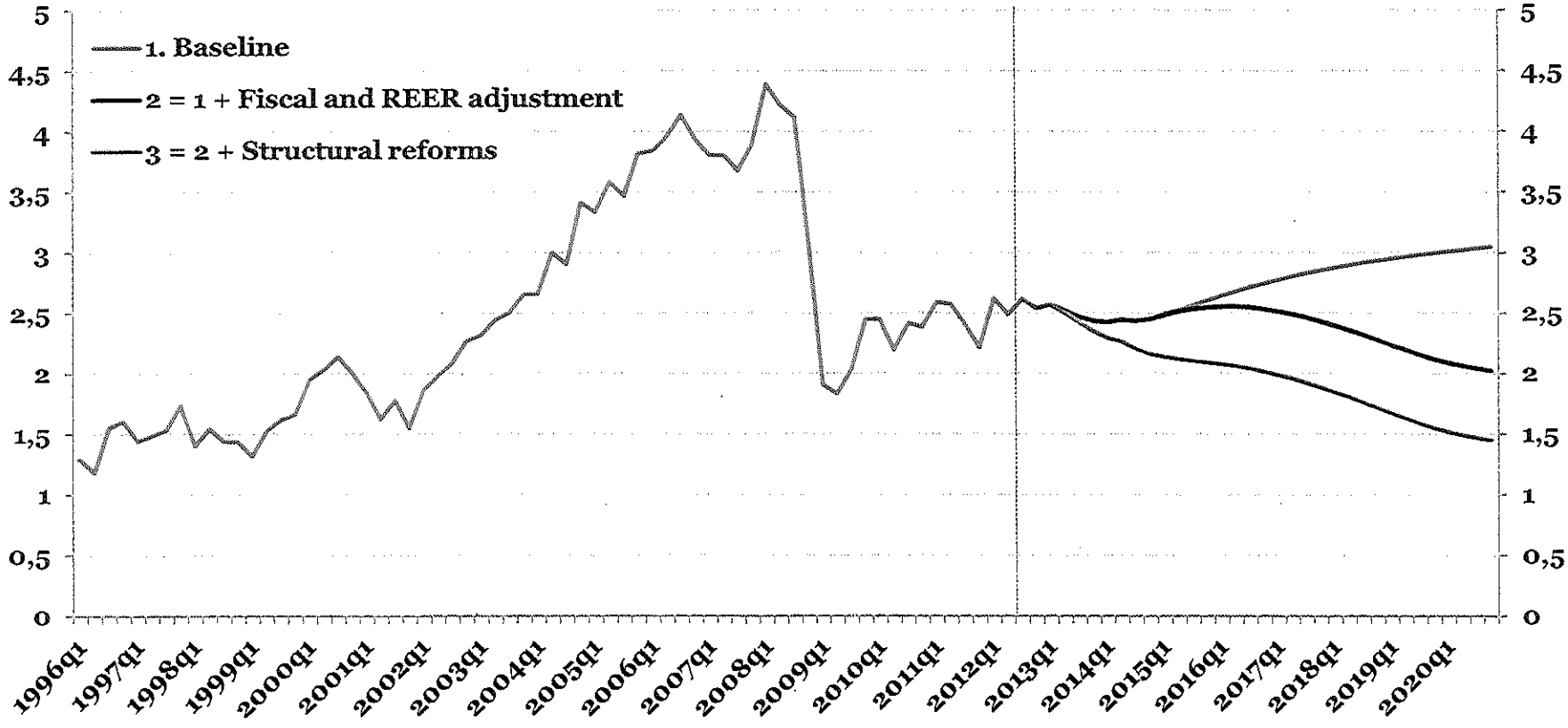



Note: Global current account imbalances: calculated as the sum of absolute current account balances in major surplus and deficit zones (% of global GDP). Business cycle-adjusted global current account imbalances: current account balances after adjusting the current account balances in major surplus and deficit zones for relative output gaps.

# Structural policies reduce imbalances

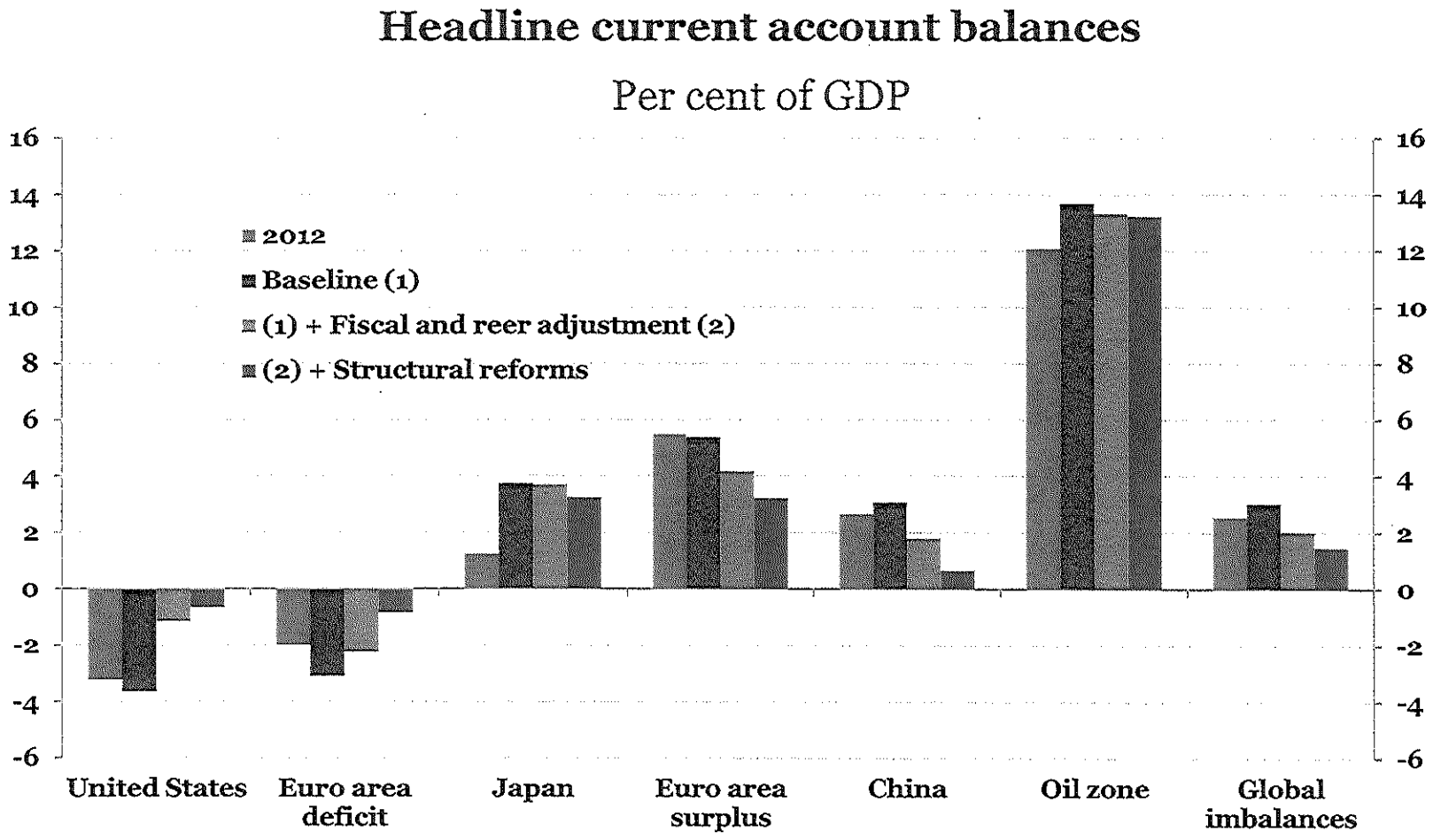
## Global current account imbalances

Per cent of world GDP




Note: Calculated as the sum of absolute current account balances as a share of global GDP.

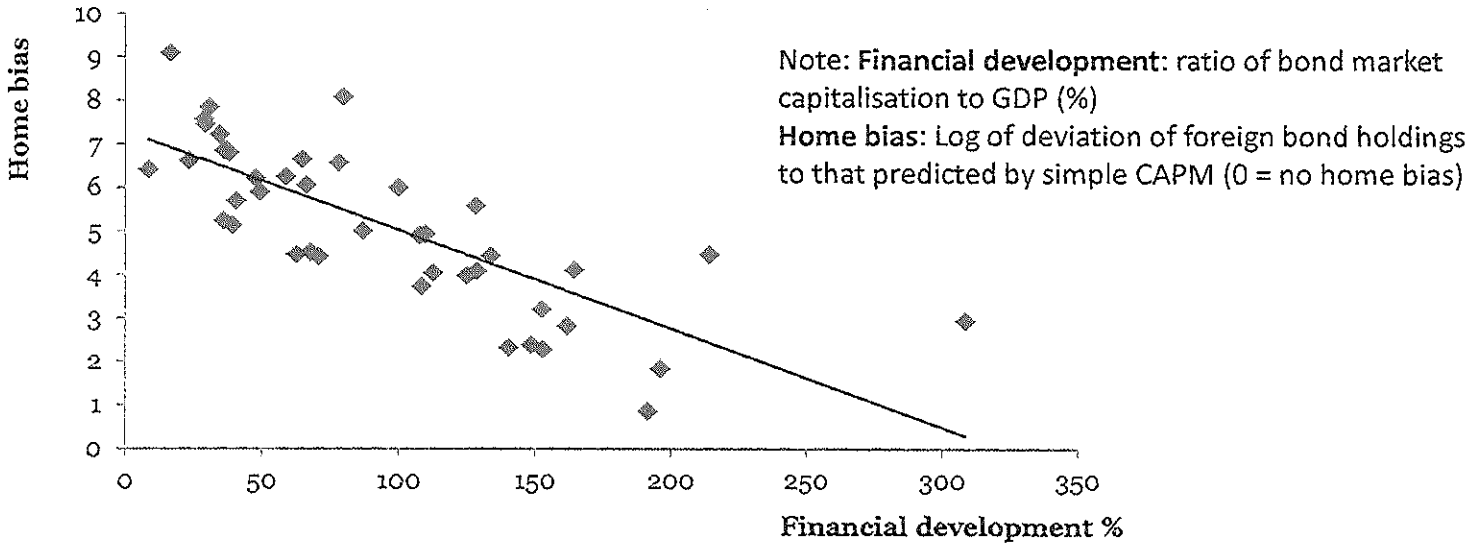
# Scenarios for imbalances, 2020




Note: Observation for the year 2012 is average of the first two quarters of 2012.

# Uphill capital flows: the role of 'safe' assets

Across countries home bias decreases with the level of financial development, 2006




- Prominent hypothesis that a lack of 'safe' assets in high growth, high saving economies leads to uphill flow of capital
- But, private-sector home bias is high in less developed financial systems (see chart)
- And, the geographical distribution of external assets of such countries is not biased in general towards assets of financially highly developed countries (though US debt securities are over-represented)

# Capital flows as the flip-side of current accounts

**Panel-data analysis of saving, investment and current accounts suggests that the following factors play a role:**

- Weaker fiscal policies in AMEs relative to EMEs
- Stronger barriers to FDI inflows in EMEs relative to AMEs
- Stronger barriers to product market competition in EMEs relative to AMEs
- Weaker social safety nets (concretely, health-care spending in regressions) in EMEs relative to AMEs
- Greater financial market repression in EMEs relative to AMEs
- The combination of weak job protection and unemployment benefits in EMEs relative to AMEs

# Capital flows: Bottom-line

- A large part of flows (including uphill) can be accounted for by:
  - Macroeconomic policy
  - Structural policy
- Not clear that 'safe' assets are a big part of the story

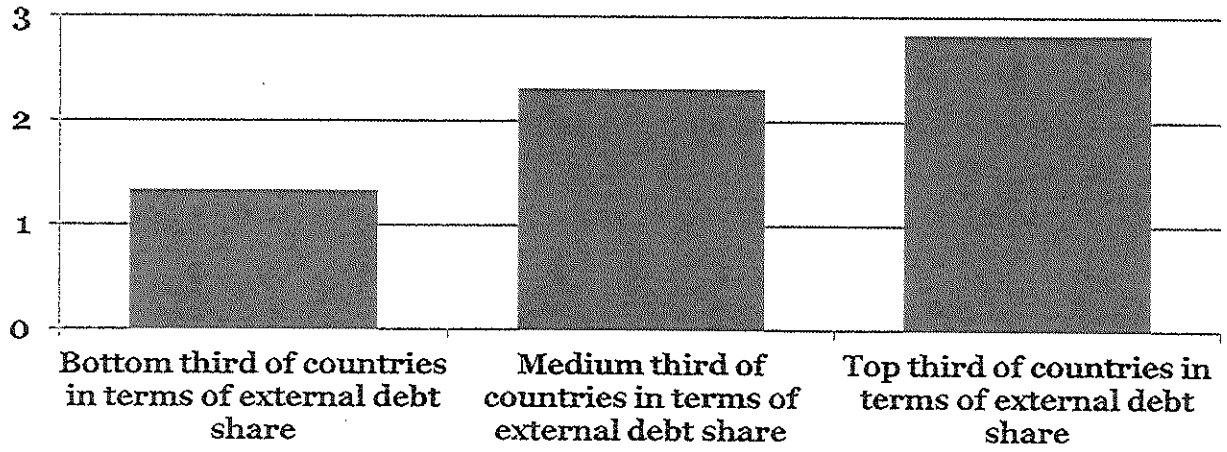
# Risk: the composition of capital flows

- Dataset covering 114 countries, 1984-2009, and 129 systemic banking crises
  - Laeven and Valencia 2010 definitions
- Econometric analysis of probability of suffering a banking crisis as a function of:
  - financial account structure
  - external financial shocks (contagion)
  - structural policy indicators
  - various controls
- Disaggregated *gross* financial flows & positions:

| | |
|---|---|
| Portfolio equity (shares) | FDI (controlling equity) |
| Portfolio debt (bonds) | Bank transactions (loans, deposits) |

# Risk: Banks are a major vector of instability

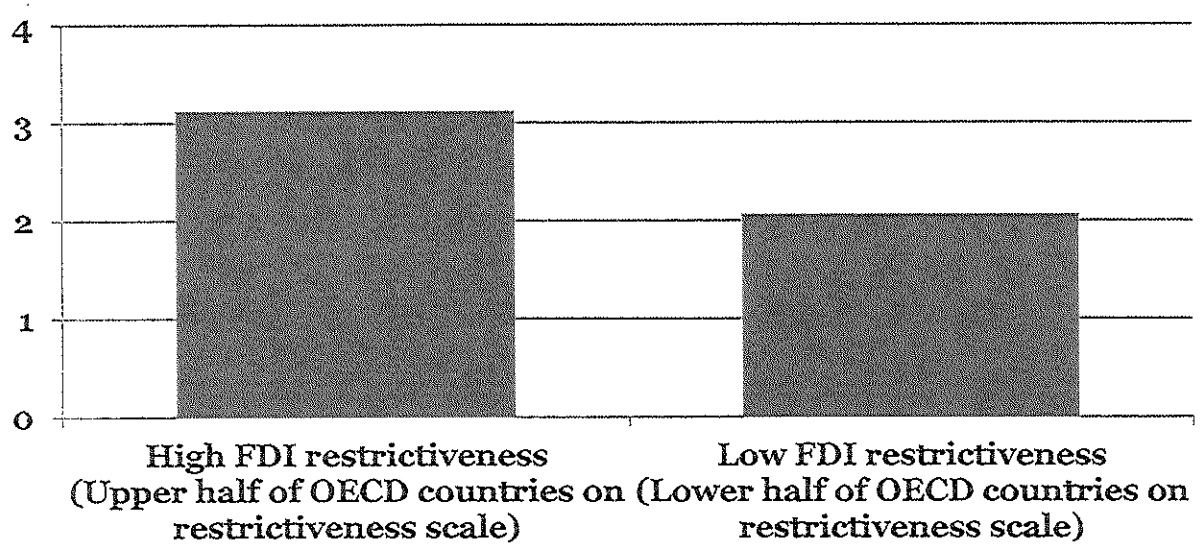
Probability of experiencing a banking crisis (per year, in %, descriptive evidence)




- The financial account structure affects stability
  - Probit analysis confirms descriptive evidence: there is a hierarchy of flows in terms of riskiness.
  - A higher share of bank and portfolio debt increase crisis risk (controlling for the overall level of foreign liabilities)
  - Short-term bank debt is most risky
- Crises abroad increase domestic risks (*contagion*)
  - Both direct contagion from lending-country shock and indirect contagion (via lending-country bank balance sheets) from shocks in third countries.

# Risk: structural policies shift the liability structure

Restrictive regulations on FDI increase crisis risk (probability, in %)




- Risks are increased by policies that increase share of debt in total liabilities:
  - barriers to FDI
  - strict product market regulation
  - tax systems favouring debt over equity finance

# Risk: banking regulation and risks

- Risks are increased by:
  - weak banking supervision
  - lax information disclosure rules
  - low capital requirements
  - strong credit growth to domestic non-financial sector
  - rapid house price increases
- Contagion risks are increased by:
  - banking sector leverage
  - low share of deposits in bank liabilities

# Risk: role of structural policies

- Structural policies can help to reduce risk by:
  - changing the *structure* of capital flows towards less fragile financing
  - cushioning contagion shocks
  - increasing domestic economic and financial stability
- Key policies include easing FDI restrictions, product market reforms, making tax systems less favourable to debt, and better prudential policies.
- Capital controls have a role at the margin, but it is limited

# Conclusions. Imbalances, capital flows, and structural reforms

- SR will help reduce imbalances
- SR will make imbalances more sustainable by reinforcing adjustment mechanisms
- And by making the capital flows less prone to instability
- Better macroeconomic and structural policies can reduce uphill capital flows